Chapter 19

Valuation of Goodwill

Goodwill is the monetary valuation of the reputation of a business. Goodwill is a self generated asset. It is an intangible asset. Goodwill is valued when

a. The profit sharing ratio among the partner changes.

b. On admission, retirement or death of a partner.

c. On dissolution of firm.

Method of Goodwill valuation

1. **Simple Average Method**

   Goodwill = No. of years $\times$ Simple Average Profit

2. **Weighted Average Method**

   Goodwill = No. of years $\times$ Weighted Average Profit

   Weighted Average Profit = Total weighted Profit / Total weights

3. **Super Profit Method**

   Goodwill = No. of years $\times$ Super Profit
   Super Profit = Future Profit – Normal Profit
   Future Profit = Average Profit +/- Future changes
   Normal Profit = Capital employed $\times \frac{NRR}{100}$
   Capital employed = Trade Assets – Outside Liabilities
   NRR = Normal Rate of Return

4. **Annuity Method**

   Goodwill = Average Profit $\times$ Annuity Value

5. **Capitalization of Profit Basis**

   Goodwill = Capitalised Value – Capital employed

   Capitalised Value - $\frac{Average\ Profit}{NRR} \times 100$

   - Averages profit should be considered after partners remuneration. While considering the past profits unusual profits if any should be ignored.

* From the following information find the value of goodwill under simple average and weighted average method. If goodwill should be valued on the basis of 2 years purchase.

a)

Year	Profit
2006	30,000
2007	33,000
2008	36,000

b)

Year	Profit
2006	36,000
2007	33,000
2008	36,000

* The average profit made by the business is 30,000/-. Find the value of goodwill under annuity method assuming rate of interest is 10%

* **<u>Methods of Goodwill Valuation</u>**

a) Simple Average Profit Mehtod

Goodwill = No. of years $\times$ Average Profit

Average Profit = $\frac{\text{Total Profit}}{\text{No. of years}}$

b) Weighted Average Profit Method

Goodwill = No. of years $\times$ Weight Average Profit

Weight Average Profit = $\frac{\text{Total Profit (weight)}}{\text{Total weight}}$

Weight Profit = Profit $\times$ Weights

c) Super Profit Method

Goodwill = No. of years $\times$ Super Profit

Super Profit = Future Profit – Normal Profit

Future Profit = Average Profit $\pm$ Future Expenses / Income

Normal Profit = Capital Employed $\times$ NRR

Capital Employed = Trade Assets – Outside Liabilities.

d) Capitalisation of Super Profit Method

Goodwill = $\frac{\text{Super Profit}}{\text{NRR}}$

e) Capitalisation of Profit Method

Goodwill = Capitalised Profit – Capital Employed

Capitalised Profit = $\frac{\text{Average Profit}}{\text{NRR}}$

f) Annuity Value Method

Goodwill = Average Profit $\times$ Annuity Value

MULTIPLE CHOICE QUESTIONS

1. Following are the factors affecting goodwill except:
   (a) Nature of business (b) Efficiency of management
   (d) Technical know how (d) Location of the customers

2. Weighted average method of calculating goodwill should be followed when:
   (a) Profits are uneven (b) Profits has increasing trend
   (c) Profits has decreasing trend (d) Either 'b' or 'c'

3. Under average profit basis goodwill is calculated by :
   (a) No. of years purchased multiplied with average profits
   (b) No. of years purchased multiplied with super profits
   (c) Summation of the discounted value of expected future benefits
   (d) Super profit divided with expected rate of return

4. Under super profit basis goodwill is calculated by :
   (a) No. of years purchased multiplied will average profits.
   (b) No. of years purchased multiplied with super profits
   (c) Summation of the discounted value of expected future benefits
   (d) Super profit divided with expected rate of return

5. Under annuity basis goodwill is calculated by :
   (a) No. of years purchased multiplied with average profits
   (b) No. of years purchased multiplied with super profits
   (c) Summation of the discounted value of expected future benefits
   (d) Super profit divided with expected rate of return

6. Under capitalization basis goodwill is calculated by :
   (a) No. of years purchased multiplied with average profits
   (b) No. of years purchased multiplied with super profits
   (c) Summation of the discounted value of expected future benefits
   (d) Super profit divided with expected rate of return

7. The profits and losses for the last years are 2001-02. Losses ₹10,000; 2002-03 Losses ₹2,500; 2003-04 Profits ₹98,000 & 2004-05 Profits ₹76,000. The average capital employed in the business is ₹2,00,000. The rate of interest expected from capital invested is 12%. The remuneration of partners is estimated to be ₹1,000 per month. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years.
   (a) ₹9,000 (b) ₹8,750 (c) ₹8,500 (d) ₹8,250

8. The profits of last five years are ₹1,70,000; ₹1,80,000; ₹1,40,000; ₹2,00,000 and ₹1,60,000. Find the value of goodwill, if it is calculated on average profits of last five year on the basis of three year's purchase.

(a) ₹1,70,000 (b) ₹5,10,000 (c) ₹5,30,000 (d) ₹5,70,000

9. The profits for the last three years are ₹40,000; 2003-04 Profits ₹60,000 & 2004-05 Profits ₹66,500. The total liabilities of the firm are ₹10,00,000 of which outsiders liabilities is ₹5,42,500. The rate of interest expected from capital invested is 10%. The value of goodwill on capitalization basis of super profit:

(a) ₹97,000 (b) ₹97,250 (c) ₹97,500 (d) ₹97,750

10. The capital of B and D are ₹90,000 and ₹30,000 respectively with the profit sharing ratio 3 : 1. The new ratio, admissible after 1.4.2006 is 5 : 3. The goodwill is valued ₹80,000 as on that date. Amount payable by a gaining partner to a scarifieing partner is:

(a) B will pay to D ₹10,000 (b) D will pay to B ₹10,000

(c) B will pay to D ₹80,000 (d) D will pay to B ₹80,000

11. The profits for 2003-2004 are ₹4,000; for 2004-2005 is ₹52,200 and for 2005-2006 is ₹62,400. Closing stock for 2004-2005 and 2005-2006 includes the defective items of ₹4,400 and ₹12,400 respectively which were considered as having market value Nil. The value of goodwill on average profit method is:

(a) ₹47,400 (b) ₹35,400 (c) ₹27,400 (d) ₹34,600

12. A, B and C are partners sharing profits and loss in the ratio 3 : 2 : 1. They decide to change their profit sharing ratio to 2 : 2 : 1. To give effect to this new profit sharing ratio they decide to value the goodwill at ₹30,000. Pass the necessary journal entry if goodwill not appearing in the old balance sheet and should not appear in the new balance sheet.

(a) B's Capital Account	Dr.	2,000	
C's Capital Account	Dr.	1,000	
To A's Capital Account			3,000
(b) Goodwill Account	Dr.	30,000	
To A's Capital Account			15,000
To B's Capital Account			10,000
To C's Capital Account			5,000
(c) A's Capital Account	Dr.	12,000	
B's Capital Account	Dr.	12,000	
C's Capital Account	Dr.	6,000	
To Goodwill Account			30,000
(d) A's Capital Account	Dr.	3,000	
To B's Capital Account			2,000
To C's Capital Account			1,000

13. Total capital employed in the firm ₹16,00,000
    Reasonable Rate of Return 15%
    Profits for the year ₹24,00,000
    The value of goodwill using capitalization method is:
    (a) ₹1,64,00,000 (b) ₹24,00,000 (c) ₹1,44,00,000 (d) ₹84,00,000

14. The profits of last five years are ₹85,000; ₹90,000; and ₹70,000; ₹1,00,000 and ₹80,000. Find the value of goodwill, if it is calculated on average profits of last five years on the basis of 3 years of purchase.
    (a) ₹2,55,000 (b) ₹2,25,000 (c) ₹2,75,000 (d) ₹2,85,000

15. The profits of last three years are ₹42,000; ₹39,000 and ₹45,000. Find out the goodwill of two years purchase.
    (a) ₹42,000 (b) ₹84,000 (c) ₹1,26,000 (d) ₹85,000

16. The capital of A and B sharing profits and losses equally are ₹90,000 and ₹30,000 respectively. They value the goodwill of the firm at ₹84,000, which was not recorded in the books. If goodwill is be raised now, by what amount each partner's capital account will be credited :
    (a) ₹21,000 and ₹63,000 (b) ₹42,000 and ₹42,000
    (c) ₹63,000 and ₹21,000 (d) None of the above

17. Find the goodwill of the firm using capitalization method from the following information :
    Total capital Employed in the firm ₹8,00,000
    Reasonable Rate of Return 15%
    Profits for the year ₹12,00,000
    (a) ₹82,00,000 (b) ₹12,00,000 (c) ₹72,00,000 (d) ₹42,00,000

18. Under capitalization basis goodwill calculated by:
    (a) No. of years purchased multiplied with average profits
    (b) No. of years purchased multiplied with super profits
    (c) Summation of the discounted multiplied with super profits
    (d) Super profit divided with expected rate of return

19. Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in ________
    (a) Profit share of the partners (b) Calculation of the goodwill
    (c) Both (d) None

20. The profits for 1998-99 are ₹2,000; for 1999-2000 is ₹26,100 and for 2000-01 is ₹31,200. Closing stock for 1999-2000 and 2000-01 includes defective items of ₹2,200 and ₹6,200 respectively which were considered as having market value NIL. Calculate goodwill on average profit method.
    (a) ₹23,700 (b) ₹17,700 (c) ₹13,700 (d) ₹17,300