Net Value OF BUSINESS IS 70 LAKHS

MARKET VALUE OF BUSINESS IS 75 LAKHS

Rs.5 lakhs extra is for what reason?

Rs.5 lakhs extra is for what reason?

Brand Name

Customers size

Suppliers

Its Workforce

Goodwill

Goodwill: Meaning and Factors Affecting

Goodwill

"Goodwill is an intangible asset linked to an established business built over time, as a business gains favorable reputation for maintaining good customers-suppliers relationship and effective branding as it is expected to make profit year after year."

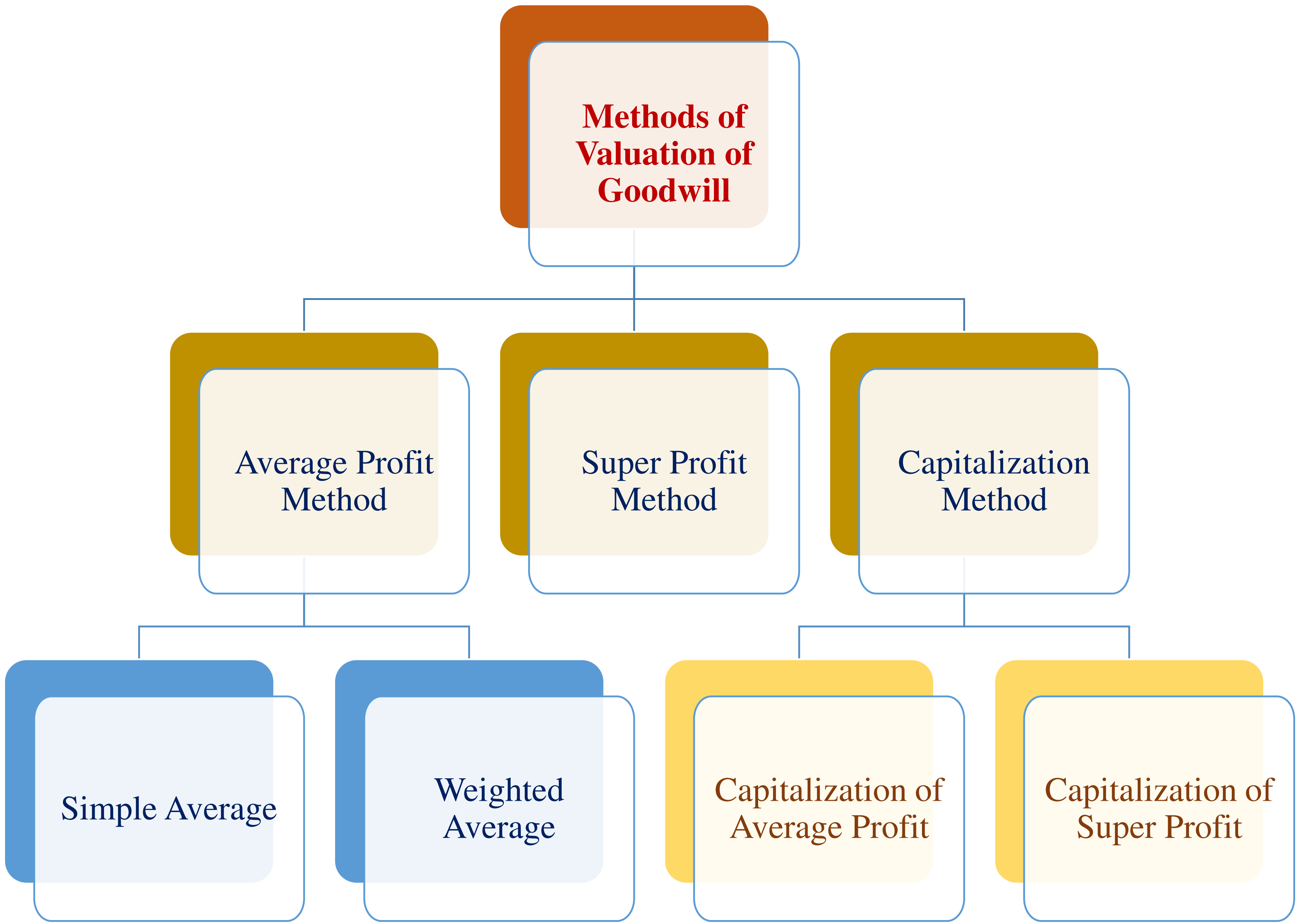
Factors of Existence of Goodwill

- Nature of Business
- Regular Customer
- Efficient Management
- Quality Maintenance
- Advantages of Patents
- Past Performance
- Risk Associated with Business
- Favourable Location

Types of Goodwill

- **Purchased Goodwill**
  - **Will be shown in books of Accounts**
- **Self Generated Goodwill**
  - **Will not be shown in books of Accounts**

Methods of Valuation of Goodwill


Methods of Valuation of Goodwill
Average Profit Method
Super Profit Method
Capitalization Method
Simple Average
Weighted Average
Capitalization of Average Profit
Capitalization of Super Profit

NOTE:- Before calculating the average profits the following adjustments should be made in the profits of the firm:

a) Any abnormal profits should be deducted from the net profits of that year.

b) Any abnormal loss should be added back to the net profits of that year.

c) Non-operating incomes e.g. income from investments etc should be deducted from the net profits of that year.

Simple Average Profit Method

Goodwill $= Average\ Profit \times Number\ of\ Year's\ Purchased$

Average profit $= \frac{Total\ Profit}{Number\ Of\ Years}$

Number of years of Purchase means the no. of years for which the firm is likely to earn the same amount of profit.

Weighted Average Profit Method Goodwill

$= Weighted\ Average\ Profit \times\ Number\ of\ Years\ Of\ Purchase$

Weighted Average Profit $= Average\ Profit\ \times\ Given\ Weights$

Super Profits Method

Goodwill is calculated on the basis of Super Profits i.e. the excess of actual profits over the average profits. For calculating Goodwill, Super Profits are multiplied by the number of year of purchase.

(i) Goodwill = Super Profits × No. of years purchased

(ii) Super Profits = Actual profits – Normal Profits

(iii) Normal profits = Capital Invested × Normal rate of return/100

1. Assets side rule

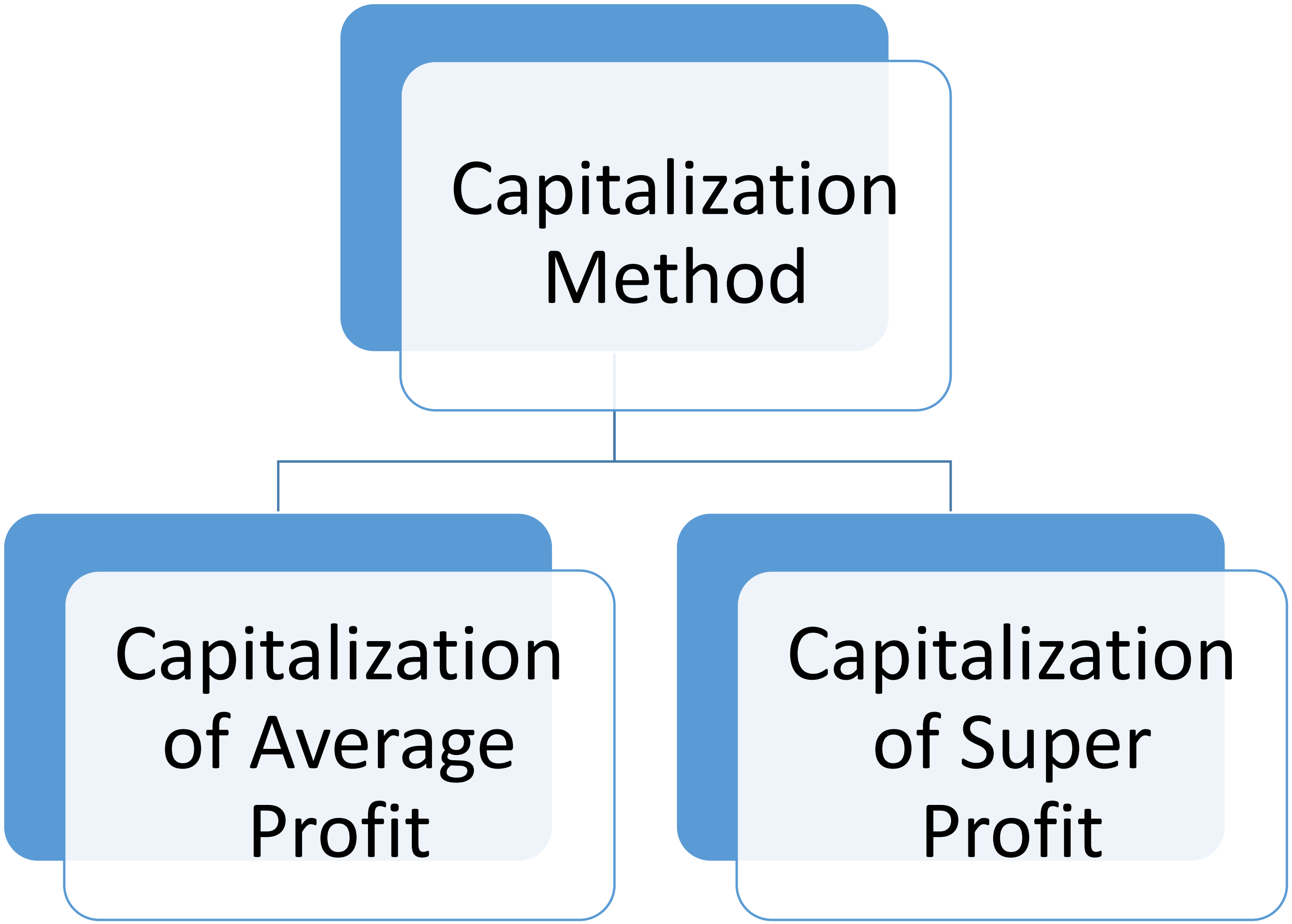
Fixed Assets +Trading Investments + Current Assets - Current Liabilities = CAPITAL EMPLOYED

2. Liability side rule:

Long Term Fund Approach

Equity Share Capital + Preference Share Capital + Reserves & Surplus + Long Term Debt - Non Trade Investments - Miscellaneous Exp. not Written Off = Capital Employed

NOTE: Non Trade Investments should not form part of Capital Employed (NON OPERATING ASSETS) EX: Fixed Deposit, Land (which is not used for business & do not yield any income)


Capitalization Method
Capitalization of Average Profit
Capitalization of Super Profit

Capitalization of Average Profits Method ⍰ Under this method we calculate the average profits and then assess the capital needed for earning such average profits on basis of normal rate of return. such capital is called capitalization value of average profit.

Capitalization of Average Profits Method ⍰ Goodwill = capitalized value of the firm - net assets

⍰ Capitalized value = $\frac{Average\ Profit}{Normal\ rate\ of\ return} \times 100$

⍰ Net assets = $total\ assets - external\ liabilities$

Capitalization of Average Profits Method

A firm earns Rs.65000 as its average profits. The usual rate of earnings is 10%.the total assets of the firm amounted to Rs.680000 and liabilities are Rs.180000.

Calculation:

- **Total Capitalization Value**

$$= \frac{65000}{10} \times 100 = 650000$$

- **Net Assets = 680000-180000 = 500000**
- **Goodwill = Total Capitalization Value – Net Assets**

= 650000 – 500000 = 150000

Capitalization of Super Profits Method Example:

Verma Brothers earn a profit of Rs. 90,000 with a capital of Rs. 4, 00,000. The normal rate of return in the business is 15%.

Calculation:-

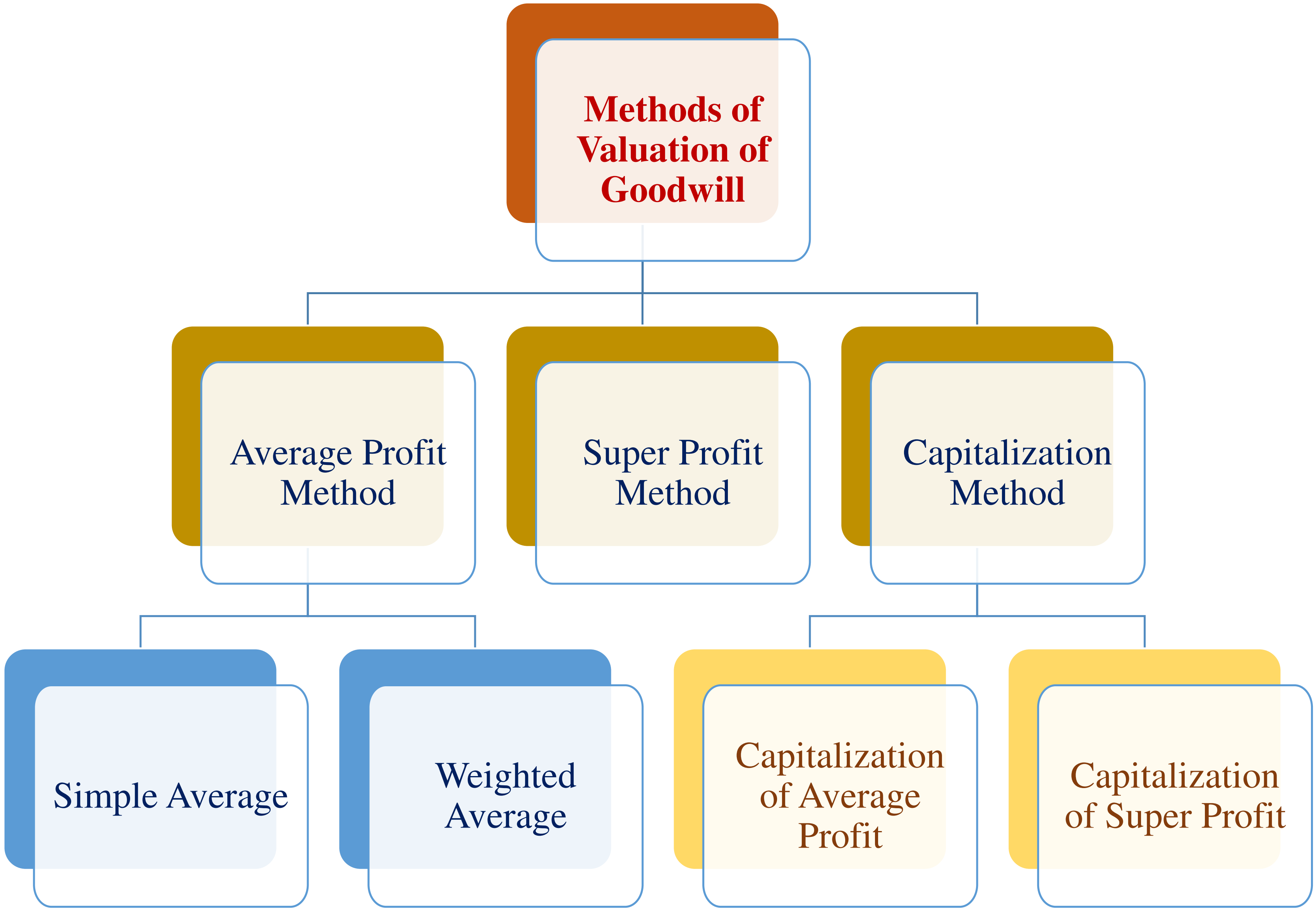
 Normal Profit = 4,00,000$\times \frac{15}{100} = Rs. 60{,}000$

 Super Profit = Rs. 90,000 – Rs. 60,000 = Rs. 30,000

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

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

Calculation of Goodwill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Average Profit Method

Goodwill $= Average\ Profit \times Number\ of\ Year's\ Purchased$

Average profit $= \frac{Total\ Profit}{Number\ Of\ Years}$

Number of years of Purchase means the no. of years for which the firm is likely to earn the same amount of profit.

Question:-Pooja purchased Sawita's business on 1st April 2019. it was agreed to value goodwill at three year's purchase of average profit of the last four years. The profit of Sawita's business for the last four years were 2016 Rs.90,000; 2017 Rs.1,60,000; 2018 Rs.1,80,000 and 2019 Rs.2,20,000. It was observed that:-

(a) During the year ended 31st March, 2016 an asset was sold at a profit of Rs.10,000.

(b) During the year 2017, a machine got destroyed in accident and Rs.30,000 written off as loss.

(c) During the year 2018, a firm's assets were not insured. Insurance premium being Rs.10,000

Average Profit Method

Solution:-

Year	2016	2017	2018	2019
Profit Less/Add: Adjustments	90,000 (10,000)	1,60,000 30,000	1,80,000 (10,000)	2,20,000
Net Profit	80,000	1,90,000	1,70,000	2,20,000

$$Total\ Profit\ = 80{,}000 + 1{,}90{,}000 + 1{,}70{,}000 + 2{,}20{,}000 = 6{,}60{,}000$$

$$Average\ Profit = \frac{6{,}60{,}000}{4} = 1{,}65{,}000$$

$$Goodwill = 1{,}65{,}000X3 = Rs.\,4{,}95{,}000$$

Weighted Average Profit Method

Goodwill $= Weighted\ Average\ Profit \times\ Number\ of\ Years\ Of\ Purchase$

Weighted Average Profit = $Average\ Profit\ \times\ Given\ Weights$

Year	2016	2017	2018	2019	Total
1. Profit Less/Add: Adjustments	90,000 (10,000)	1,60,000 30,000	1,80,000 (10,000)	2,20,000	
2. Net Profit	80,000	1,90,000	1,70,000	2,20,000	
3. Weights	1	2	3	4	10
4. Weighted Profits (2 × 3)	80,000	3,80,000	5,10,000	8,80,000	18,50,000

$$Weighted\ Average\ Profit = \frac{Total\ Weighted\ Profit}{Total\ Weights} = \frac{18{,}50{,}000}{10} = Rs.\,1{,}85{,}000$$

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

$$= 1{,}85{,}000 \times 3 = Rs.\,5{,}55{,}000$$

Super Profit Method

Goodwill $= \text{Super } Profit \times \ Number\ of\ Years\ Of\ Purchase$

$$Super\ Profit = Average\ Profit - Normal\ Profit$$

$$Average\ Profit = \frac{Total\ Profits}{Number\ of\ years}$$

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

Question:- A business earned an average profit of Rs.4,00,000 during the last few years. The normal rate of profit in the similar type of business is 10%. The total value of assets and liabilities of the business were Rs.11,00,000 and Rs.2,80,000 respectively. Calculate goodwill of the firm on 3 years purchase of super profit.

Solution:-

Capital Employed$= Assets - Liabilities = 11{,}00{,}000 - 2{,}80{,}000$

$$= Rs.\,8{,}20{,}000$$

$$Normal\ Profit = 8{,}20{,}000 \times \frac{10}{100} = Rs.\,82{,}000$$

$$Super\ Profit = Average\ Profit - Normal\ Profit$$

$$= 4{,}00{,}000 - 82{,}000 = Rs.\,3{,}18{,}000$$

$$Goodwill = 3{,}18{,}000 \times 3 = Rs.\,9{,}54{,}000$$