Class-12 Accountancy
Chapter 2 - Goodwill

Introduction

The word goodwill is very easy to describe but very difficult to define. The good reputation earned by a business is the result of hard work and efficiency of the management. When a business gets good name or reputation, his sales and profits go on increasing. This reputation is known as goodwill. The future of business depends upon this reputation. Goodwill attracts the customers towards products of the business. A business firm who is continuously doing well and earning profits, only that firm will earn goodwill. It is shown in the assets side in the balance sheet under the head fixed assets.

Goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. Whenever a business is acquired for a price (payable in cash or in shares or otherwise) which is in excess of the value of the net assets of the business taken over, the excess should be termed as 'goodwill'.

Meaning and Definition of Goodwill

Over a period of time, a well established business develops an advantage of good name, reputation and wide business connections. This good name and reputation of the business help in earning more and more profits. Goodwil places the organization at a good position due to which the organization is able to earn higher profits without any extra efforts. Goodwil cannot be seen but felt. Therefore, goodwil is called an Intangible asset.

Some Important Definitions of Goodwill

According to Eric L. Kohlar_ "Goodwill is the excess of the price paid for a business as a whole over the book values or over the computed value of all tangible assets purchased. Normally, goodwill thus acquired is only one type appearing on books of account and in financial statements."

According to Professor Dicksee "When a man pays for goodwill he pays for something which places him in a position of being able to earn more money than he would be able to do by his own unaided efforts. Thus, the capacity of a business to earn profits in future is basically what is meant by term goodwill."

According to Spicer and Pegler__" Goodwill may be said to be that element arising from the eputation, connections or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business."

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Factors Giving Rise to Goodwill

(i) **Nature of Business** : Goodwill of the firm depend upon the nature of business. A business firm providing high quality goods to its customers will earn more profits and therefore has more goodwill.

(ii) **Location** : Location of the business is also an important factor in earning more profits and more goodwill. If the location of business firm is good or business is located at a place having heavy customer traffic, the goodwill tends to be high.

(iii) **Efficiency of Management** : A business will earn more profits and good reputation only if the management is efficient. A well managed business firm enjoys the advantage of high productivity and cost efficiency. It helps in earning more profits and so the value of goodwill will also be high.

(iv) **Market Situation** : If there is no competition or there are less competitors in the market, the business firm will earn more profits which leads to higher value of goodwill.

(v) **Special Advantages** : A business firm who enjoys special advantages like import licences, tax holiday, free or low rate electricity, long term contracts for supply of materials etc. will enjoy the higher value of goodwill.

Need for valuation of goodwill

Normally, the need for valuation of goodwill arises at the time of the sale of a business. Whenever the mutual rights of the partners changes then party which makes a sacrifice must be compensated. This basis of compensation is goodwil so we need to calculate goodwil . Mutual rights change under following circumstances

1) When there is change in the profit sharing ratio amongst the existing partners

2) At the time of admission of a new partner

3) At the time of retirement of a partner

4) At the time of Death of a partner

5) When amalganation of two firms taken place.

6) When partnership business is sold.

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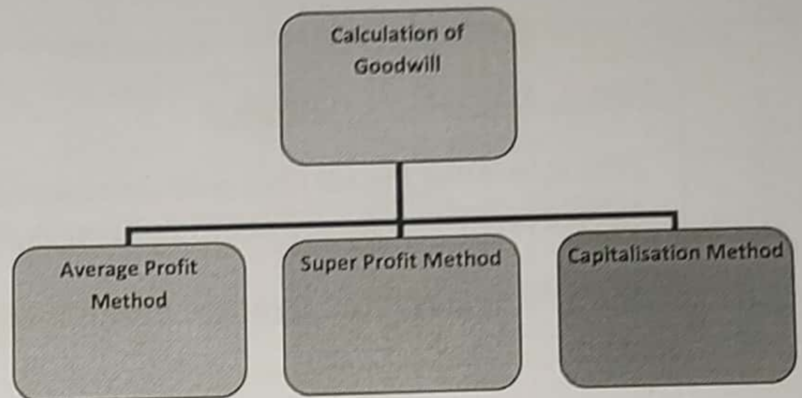
Methods for Valuation of Goodwill

Average Profit Method



This method is based on the assumption that a new business firm will not be able to earn high profits in the first few years of its operations. That is why goodwill is valued at an agreed number of years purchase of the average profits of the past few years.

The profit earned by a Firm during previous accounting periods on an average basis is called average profit. Goodwil is calculated on the basis of average profit due to future expectations of earning capacity of the firm.

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Steps of Calculating the Average Profits

Step 1. Calculate the adjusted Profits:

Sometimes profits for last few years are given with some adjustments. To calculate the adjusted profits :

- ✓ Add Non Recurring Losses and Non Business Expenses.
- ✓ Add Recurring Incomes and Gains.
- ✓ Deduct Non Recurring incomes and Gains.
- ✓ Deduct Recurring expenses and losses.

Step 2. Calculate Average Profit :

Average Profits = Adjusted profits/No. of years

Example : Profits of a Business for the last 3 years were :

Year 2012	Rs.60,000 (after charging abnormal loss or Rs.20,000)
Year 2013	Rs.1,00,000 (including abnormal gain of Rs.60,000)
Year 2014	Rs.2,00,000 (Excluding Rs.80,000 as manager salary, He will get every year)

Solution :

Year 2012	(60,000 + 20,000) =	80,000
Year 2013	(1,00,000 – 60,000) =	40,000
Year 2014	(2,00,000 – 80,000) =	1,20,000
Total		2,40,000

Adjusted Average Profit = 2,40,000/3 = 80,000

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Step 3. Calculate Goodwill :

After calculating the adjusted profit calculated goodwill by multiplying the adjusted profit with Agreed No. of Years Purchase.

Goodwill = Adjusted Average Profit x No. of Years Purchase

Weighted Average Profit Method :

When the profits are increasing at decreasing trend it is better to use the weighted average profit method. This method is modified version of average profit method. This method is better than the simple average method because it gives weightage to latest profit, which is likely to be maintained in the future by the firm. It is applicable when the profit shows a rising or falling trend. To calculate the goodwill by weighted average profit method, following steps should be taken:

Step 1. Multiply each years profits with the respective number of weights i.e., 1 ,2 , 3, 4, 5 etc., in order to find out the value of total products.

Step 2. Calculate weighted average profit : Total of Products of profits/total of weights

Step 3. Calculate the Goodwill: Weighted average profits x Agreed No. of years purchase

Super Profit Method

The Term super profit is described as excess profit of a business made over normal profit. In simple words, it is the difference (excess) between Average Annual Earning (actual) of the business and the expected or normal return on capital invested.

To calculate the goodwill under super profit method , first we calculate the actual average profit and than Normal Profit (which is calculated on the basis of capital employed) difference of average profit and normal profit is known as super profit.

If a firm earns higher profit in comparison to normal profit (generaly earned by other firms of same industry) then the difference is called Super Profit. Goodwil is calculated on the basis of Super profit due to future expectations of learning capacity of the firm.

Super profit = Average profit - Normal profit

Normal Profit = Investment (Capital Employed) x Normal Rate of Return/100

Distinction Between Average Profit Method and Super Profit Method

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Basis	Average Profit Method	Super Profit Method
Meaning	This is the average of last few years profit divided by No. of years.	This is the excess of average profit over normal profits
Calculation of Goodwill	Average Profit x No. of years Purchase	Super Profit x No. of years purchase

Capitalisation Method

In this method capitalized value of the firm is calculated on the basis of normal rate of return. Difference between the capitalized value and actual capital employed is called goodwill.

Capitalisation of Average Profit

Under this method, to find out the value of goodwill, deduct the actual capital employed (net assets) in the business from the capitalized value of the average profits on the basis of normal rate of return. This involves the following steps:

(i) First of all find out the average profit (on the basis of last few years profit)

(ii) Capitalize the average profits on the basis of the normal rate of return to ascertain the capitalised value of average profits as follows:

Average Profits × 100/Normal Rate of Return

(iii) Find out the actual capital employed (net assets) by deducting outside liabilities from the total assets (excluding goodwill).

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

(iv) To find out the value of goodwill deduct net assets from the capitalised value of average profits, i.e. (iii) – (iv).

Capitalisation of Super Profit

Sometimes Goodwill can also be calculated by capitalising the super profit directly. Under this method there is no need to work out the capitalised value of average profits. It involves the following steps.

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