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THE BEST TUTORIALS

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ADVANCED ACCOUNTING **VALUATION OF GOODWILL**

Methods of Valuation of goodwill

1) Average Profit Method/ Purchase of Past profits method

Goodwill = Average Profits (Adjusted) X Number of years purchase

Average (Adjusted) Profits= $\frac{\text{Total Adjusted profits}}{\text{No of years profits given}}$

Actual Profits	= xx
Add: Abnormal Loss	= xx
Add: Non- recurring Expenses	= xx
Less: Non- recurring Income	= (xx)
Less: Income from investment	= (xx)
Adjusted Profits	xx

2) Weighted Average of profits method

Goodwill = Weighted Average Profits X No of years purchase

Weighted Average Profits = $\frac{\text{Total weighted Profits}}{\text{Total of weights}}$

Year	Adjusted Profits	Weights	Weighted Profits
2009		1	
2010		2	
2011		3	
		6	

3) Capitalization Method

Goodwill = Capitalized value of average adjusted profits – Actual capital employed

Capitalized Value of average profits = Average Profits X $\frac{100}{\text{Normal rate of return}}$

Actual capital employed/ Net Tangible Assets = Fixed Assets + Current Assets – outside liabilities

OR

= Equity Share capital + Preference Share Capital + Reserve & Surplus –Fictitious Assets – Investment outside business

4) Super Profit Method

Goodwill = Super Profits X No of years purchase

Super Profits = Average Profits (Adjusted) ---Normal Profits

Normal Profits = Capital Employed X $\frac{\text{Normal Rate of Return}}{100}$

5) Capitalization of Super Profits Method

Goodwill = Super Profits $\frac{\text{X 100}}{\text{Normal rate of return}}$

6) Annuity Method

Goodwill = Super Profits X Annuity Reference

Question1 (00 A) Calculate the value of goodwill at 3 years' purchase of average profits for past 4 years. The profits are 2009 Rs 20200; 2010 Rs 24800; 2011 Rs 2000; 2012 Rs 30000

On 1st September 2011, major repair of plant was charged to revenue as Rs 6000. It is agreed to capitalize it subject to depreciation of 10% p.a. on reducing instalment. The closing stock of 2010 was overvalued by Rs 2400. To cover partner's remuneration a sum of Rs 4800 p.a. shall have to be incurred.

Answer— **COMPUTATION OF ADJUSTED PROFITS**

	2009	2010	2011	2012
Annual Profits	20,200	24,800	20,000	30,000
Add: Capitalized Exp. wrongly treated as revenue	---	---	6000	--
Less: Depreciation	--	--	(200)(6000X 10% X4/12)	(580)(6000—200=5800X10%)
Less: Overvaluation of c/stock		(2400)		
Add: Overvaluation of o/stock			2400	
Less: Partners' Remuneration	(4800)	(4800)	(4800)	(4800)
	15,400	17,600	23,400	24,620

COMPUTATION OF WEIGHTED PROFITS

Year	Adjusted Profits	Weights	Weighted Profits
2009	15,400	1	15,400
2010	17,600	2	35,200
2011	23,400	3	70,200
2012	24,620	4	98,480
		10	2,19,280

Average weighted Profits = 219280 /10 = 21928

Goodwill = Weighted Average Profits X No of years Purchase

= 21928 X 3 = 65784

Average Profits = /4 = 20255

Goodwill = Average Profits X No of year Purchase

= 20255 X 3 = 60765

Question 2 (01 A)—Find out the value of goodwill from the particulars given below:

a) Average capital employed in business Rs 50000
b) Trading Results: 2009 Profit Rs 12200: 2010 Profit Rs 15000; 2011 Loss Rs 2000; 2012 Profit Rs 21000
c) Market rate of return on investment 8%.
d) Rate of risk return on capital invested in business 2%.
e) Remuneration from alternative employment of proprietor (if not engaged in business) Rs 3600 p.a.

You are required to calculate the value of goodwill on the basis of 3 years purchase of Super Profits calculated on the average profits of last 4 years.

Answer-- Goodwill = Super Profit X3 years Purchase

Average Profits = $\frac{12200 + 15000 - 2000 + 112500}{4}$ = 46200/4 = 11550

Average Profits = 11550

Less: Fair Remuneration	= (3600)	
	7950	
Less: Normal Profits (50,000 X 10%)	= (5000)	
Super Profits	= 2950	

Goodwill = 2950 X 3 = 8850

Question 3 (02 A)— A purchased B's business on 1Jan, 2001. The profits of B's business for the last three years were as follows:

1998 – Rs 40000 (including an abnormal gain of Rs 5000)

1999—Rs 50000 (After charging an abnormal loss of Rs 10,000)

2000—Rs 45000 (Excluding Rs 5000 as insurance premium of business property now to be insured)

Calculate the value of firm's goodwill on the basis of 2 years' purchase of the average profits of the last three years.

Answer—Goodwill = Average (Adjusted) Profits X 2 Years Purchase

Profit for 1998	=40,000	
Less: Abnormal Gain	(5000)	35,000
Profit for 1999	= 50,000	
Add: Abnormal Loss	= 10000	60,000
Profit for 2000	= 45000	
Less: Insurance	= (5000)	40,000
Total Profits of 3 years		1,35,000

Average Profits = 135000/3 = 45000

Goodwill = 45000 X 2 = 90,000

Question 4 (04 S)—Calculate value of goodwill on the basis of following information:

(1) Average capital employed in business –Rs 7,00,000
(2) Net trading profits of the firm for the last three years Rs 107600, Rs 90700 and Rs 112500.
(3) Rate of return expected from capital having regard to the risk involved –12%.
(4) Fair remuneration to the partners for their services Rs 12000 p.a.
(5) Sundry assets of the firm—Rs 31329
(6) Take three years' purchase of the super profits for calculating the value of goodwill.

Answer-- Goodwill = Super Profit X3 years Purchase

Average Profits = $\frac{107600 + 90700 + 112500}{3}$ = 1,03,600

Average Profits	= 103600
Less: Fair Remuneration	= (12000)
Average Adjusted Profits	= 93,600
Less: Normal Profits (7,00,000 X 12%)	= (84000)
Super Profits	7600

Goodwill = 7600 X 3 = 22,800

Question 5 (05 A, 09A) – Calculate the value of goodwill at 2 year's purchase of super profit from the following information:-

Average capital employed Rs 12,00,000. Company declared dividend @ 15% on share on Rs 20 paid up but quoted in the market at Rs 25. Trading profit for three years Rs 215200, Rs 181400 and Rs 225000.

Answer—Goodwill = Super Profit X2 years Purchase

Normal Rate of return = Dividend Rate / Market value X Paid up value = 15/25 X 20 = 12%

Average Profits = (215200 + 181400 + 225000) / 3 = 207200

Average Profits	= 207200
Less: Normal Profits(1200000X 12%)	= 144000
Super Profits	= 63200

Goodwill = 63200 X 2 = 126400

Question 6 (08 A)—The average net profit was (before adjustment) Rs 414000. It is included investment income of Rs 4000. The cost of investment was Rs 1,00,000. Expenses amounting to Rs 6000 p.a. are likely to be discontinued in future. Tax rate is 50%. Six per cent represented a fair return. The average tangible capital employed was Rs 27,00,000 but upto valuations obtained, the capital was valued at Rs 29,00,000. Assuming 5 years' purchase, what is the value of goodwill?

Answer-- Goodwill = Super Profit X5 years Purchase

Average Net Profits	= 4,14,000
Less: Income From Investment	= (4000)
	4,10,000
Add: Non recurring Expenses	(6000)
	4,16,000
Less: 50% Tax	(2,08,000)
Profits after tax	2,08,000
Less: Normal Profits (29,00,000 X 65)	(1,74,000)
Super Profits	= 34000

Goodwill = 34000 X 5 = 1,70,000

Question 7 –Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made upto 31st December every year.

The partnership deed provided, inter alia that:

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto date of death after deducting interest @ 8% on capital employed and fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2013, Wise died and it was agreed to adjust goodwill in the capital accounts without showing any amount of goodwill in the balance sheet.

It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be Rs 15000 p.a. and that the capital employed would be Rs 156000.

Clever and Dull were to continue the partnership, sharing profits and loss equally after the death of Wise. Following were the amounts of profits of earlier years before charging interest on capital employed: 2010 Rs 67200; 2011 Rs 75600; 2012 Rs 72000 and 2013 Rs 62400

You are required to compute the value of goodwill and show the adjustment thereof in the books of the firm.

Answer— Goodwill = Super Profit X3 years Purchase

Calculate Profit from 1.7.2010 to 30.6.2013

Profit from 1.7.2010 to 31.12.2013 (67200 X 6/12) = 33600

Profit for 2011		= 75600
Profit for 2012		= 72000
Profit from 1.1.2013 to 30.6.2013(62400 X 6/12)		= 31200
		2,12,400
Average Profits (212400/3)	= 70800	
Less: Fair Remuneration (15000 X 3)	= (45000)	
Less: Interest on capital (156000 X 8%)	= (12480)	
Super Profits	**13320**	

Goodwill = 13320 X 3 = 39960

Wise's share of goodwill = 39960 X 4/10 = 15984

Date	Particulars	LF	Debit	Credit
	Clever's Capital Dr.		7992	
	Dull's Capital Dr		7992	
	To Wise's Capital A/c			15984
	(Being entry of goodwill passed)			

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Don't wait for Opportunity, create it......................................

The Real Risk is Doing Nothing...........................

Your future is created by what you do today not tomorrow................