

Class 12th
CBSE - Accounting for partnership firm
Chapter 2: Goodwill nature and valuation
Vidhi Commerce Classes - CA Vidhi Jain
(Commerce ki पाठशाला)

1. MEANING OF GOODWILL

Goodwill is an intangible asset of a business. It represents the value of a firm's reputation, customer loyalty, brand name, location, and other non-physical advantages which help the firm earn super-normal profits.

In simple words, goodwill is the benefit and advantage of a good name, reputation, and connections of a business.

2. DEFINITIONS OF GOODWILL

- According to Lord Eldon: "Goodwill is nothing more than the probability that old customers will resort to the old place."
- According to Accounting Standard (AS-26): "Goodwill is an intangible asset arising from business connections, reputation, or other advantages."

3. FEATURES / CHARACTERISTICS OF GOODWILL

4. Intangible Asset – Cannot be seen or touched

5. Valuable Asset – Helps earn higher profits

6. Non-Identifiable – Cannot be separated from business

7. Arises Over Time – Built through years of good service

8. Depends on Profit Earning Capacity

4. FACTORS AFFECTING VALUE OF GOODWILL

5. Nature of Business

6. Location of Business

7. Efficiency of Management

8. Market Situation

9. Quality of Products or Services

10. Monopoly Rights

11. Favourable Government Policies

12. Business Risks

5. NEED FOR VALUATION OF GOODWILL

Valuation of goodwill is required at the time of:

1. Admission of a Partner
2. Retirement of a Partner
3. Death of a Partner
4. Change in Profit Sharing Ratio
5. Sale of Business
6. Amalgamation of Firms

6. METHODS OF VALUATION OF GOODWILL

Goodwill can be valued by the following methods:

1. Average Profit Method
2. Super Profit Method
3. Capitalisation Method

Flow Chart: Goodwill Valuation Methods → Average Profit Method → Super Profit Method → Capitalisation Method

7. AVERAGE PROFIT METHOD

Under this method, goodwill is calculated on the basis of average profits of past years.

FORMULA: Goodwill = Average Profit × Number of Years' Purchase

7.1 SIMPLE AVERAGE PROFIT METHOD

Steps:

1. Find total profits of past years
2. Divide by number of years
3. Multiply by years' purchase

7.2 WEIGHTED AVERAGE PROFIT METHOD

Used when profits show a rising or falling trend.

FORMULA: Weighted Average Profit = Total of Weighted Profits / Total of Weights

Goodwill = Weighted Average Profit × Years' Purchase

8.SUPER PROFIT METHOD

Super profit is the excess of actual profit over normal profit.

FORMULAS: Normal Profit = Capital Employed × Normal Rate of Return
Super Profit = Average Profit – Normal Profit
Goodwill = Super Profit × Years' Purchase

9.CAPITALISATION METHOD

Under this method, goodwill is valued by capitalising profits.

Two Approaches:

1. Capitalisation of Average Profit
2. Capitalisation of Super Profit

9.1 CAPITALISATION OF AVERAGE PROFIT

FORMULA: Capitalised Value = Average Profit × 100 / Normal Rate
Goodwill = Capitalised Value – Actual Capital Employed

9.2 CAPITALISATION OF SUPER PROFIT

FORMULA: Goodwill = Super Profit × 100 / Normal Rate

10.IMPORTANT TERMS

• Average Profit • Super Profit • Normal Profit • Capital Employed • Normal Rate of Return • Years' Purchase

11.CAPITAL EMPLOYED – MEANING & CALCULATION

Capital Employed means total investment made in the business.

Capital Employed = Total Assets – Outside Liabilities

12. ADJUSTMENTS WHILE CALCULATING PROFITS

13. Abnormal profits – deducted
14. Abnormal losses – added back
15. Non-recurring items – adjusted
16. Provision for tax – considered if required

13. COMPARISON OF METHODS

Average Profit Method: • Simple • Based on past profits

Super Profit Method: • Scientific • Considers normal return

Capitalisation Method: • Most logical • Used for big firms

14. COMMON EXAM MISTAKES

- Ignoring abnormal items
- Wrong calculation of capital employed
- Not adjusting past profits
- Using wrong normal rate

15. EXAMINATION TIPS

- Always write formula
- Show full working notes
- Use proper headings
- Practice numericals regularly

NUMERICAL 1: Average Profit Method (Simple Average)

The profits of a firm for the last 5 years were:

₹20,000, ₹25,000, ₹30,000, ₹35,000, ₹40,000

Calculate goodwill at **3 years' purchase**.

Solution:

Total Profits

$$= 20,000 + 25,000 + 30,000 + 35,000 + 40,000$$

$$= ₹1,50,000$$

Average Profit

$$= 1,50,000 \div 5$$

$$= ₹30,000$$

Goodwill

$$= \text{Average Profit} \times \text{Years' Purchase}$$

$$= 30,000 \times 3$$

$$= \mathbf{₹90,000}$$

NUMERICAL 2: Weighted Average Profit Method

Profits for last 4 years:

Year	Profit (₹)	Weight
2022	20,000	1
2023	25,000	2
2024	30,000	3
2025	35,000	4

Goodwill is valued at **2 years' purchase**.

Solution:

Weighted Profits:

- $20,000 \times 1 = 20,000$

- $25,000 \times 2 = 50,000$

- $30,000 \times 3 = 90,000$

- $35,000 \times 4 = 1,40,000$

$$\text{Total Weighted Profit} = ₹3,00,000$$

$$\text{Total Weights} = 10$$

Weighted Average Profit

$$= 3,00,000 \div 10$$

$$= ₹30,000$$

Goodwill

$$= 30,000 \times 2$$

$$= ₹60,000$$

NUMERICAL 3: Super Profit Method

Average profit = ₹50,000

Capital employed = ₹4,00,000

Normal rate of return = 10%

Years' purchase = 3

Solution:

Normal Profit

$$= 4,00,000 \times 10\%$$

$$= ₹40,000$$

Super Profit

$$= \text{Average Profit} - \text{Normal Profit}$$

$$= 50,000 - 40,000$$

$$= ₹10,000$$

Goodwill

$$= \text{Super Profit} \times \text{Years' Purchase}$$

$$= 10,000 \times 3$$

$$= ₹30,000$$

NUMERICAL 4: Capitalisation of Average Profit

Average profit = ₹60,000

Normal rate of return = 12%

Actual capital employed = ₹4,00,000

Solution:

Capitalised Value of Business

$$= 60,000 \times 100 / 12$$

$$= ₹5,00,000$$

Goodwill

$$= \text{Capitalised Value} - \text{Actual Capital}$$

$$= 5,00,000 - 4,00,000$$

$$= ₹1,00,000$$

NUMERICAL 5: Capitalisation of Super Profit

Super profit = ₹15,000

Normal rate of return = 10%

Solution:

Goodwill

$$= \text{Super Profit} \times 100 / \text{Normal Rate}$$

$$= 15,000 \times 100 / 10$$

$$= ₹1,50,000$$

NUMERICAL 6: Average Profit with Abnormal Item

Profits for last 3 years:

₹40,000, ₹50,000, ₹60,000

Included abnormal profit of ₹10,000 in last year.

Goodwill at 2 years' purchase.

Solution:

Adjusted Profit of last year

$$= 60,000 - 10,000$$

$$= ₹50,000$$

Total Adjusted Profit

$$= 40,000 + 50,000 + 50,000$$

$$= ₹1,40,000$$

Average Profit

$$= 1,40,000 \div 3$$

$$= ₹46,667$$

Goodwill

$$= 46,667 \times 2$$

$$= ₹93,334 \text{ (approx.)}$$

NUMERICAL 7: Goodwill on Admission (Super Profit)

Average profit = ₹80,000

Capital employed = ₹6,00,000

Normal rate = 10%

New partner's share = 1/4

Solution:

Normal Profit

$$= 6,00,000 \times 10\%$$

$$= ₹60,000$$

Super Profit

$$= 80,000 - 60,000$$

$$= ₹20,000$$

Total Goodwill (3 years purchase assumed)

$$= 20,000 \times 3$$

$$= ₹60,000$$

New Partner's Share

$$= 60,000 \times 1/4$$

$$= ₹15,000$$

NUMERICAL 8: Goodwill on Retirement (Average Profit)

Average profit = ₹90,000

Years' purchase = 2

Retiring partner's share = 1/3

Solution:

Total Goodwill

$$= 90,000 \times 2$$

$$= ₹1,80,000$$

Retiring Partner's Share

$$= 1,80,000 \times 1/3$$

$$= ₹60,000$$

NUMERICAL 9: Capital Employed Calculation

Assets = ₹8,00,000

Liabilities = ₹2,00,000

Average profit = ₹70,000

Normal rate = 10%

Solution:

Capital Employed

= Assets – Liabilities

= 8,00,000 – 2,00,000

= ₹6,00,000

Normal Profit

= 6,00,000 × 10%

= ₹60,000

Super Profit

= 70,000 – 60,000

= ₹10,000

NUMERICAL 10: Mixed Method

Average profit = ₹1,20,000

Capital employed = ₹10,00,000

Normal rate = 10%

Solution:

Normal Profit

= 10,00,000 × 10%

= ₹1,00,000

Super Profit

= 1,20,000 – 1,00,000

= ₹20,000

Goodwill (Capitalisation Method)

= 20,000 × 100 / 10

= ₹2,00,000

A. CONCEPT FLOW CHARTS (VERY IMPORTANT)

1. Nature of Goodwill – Concept Flow

Reputation of Business



Customer Loyalty



Extra Earning Capacity



Super Profits



GOODWILL

● Exam Use:

Asked as: “Explain the nature of goodwill.”

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2. When Does Goodwill Arise? (Flow Chart)

Existence of Super Profits



Business Earns More than Normal Profit



Buyers Willing to Pay Extra



Goodwill Comes into Existence

● Golden Rule:

✗ No super profit → No goodwill.

3. Need for Valuation of Goodwill (Flow Chart)

Admission of Partner



Retirement of Partner



Death of Partner



Change in Profit Sharing Ratio



Sale of Business

B. VALUATION METHODS – FLOW CHARTS

4. Methods of Valuation of Goodwill

Goodwill Valuation

-- Average Profit Method

-- Super Profit Method

-- Capitalisation Method

5. Average Profit Method – Flow Chart

Past Profits of Previous Years



Adjust Abnormal Items



Calculate Average Profit



Multiply by No. of Years' Purchase



GOODWILL

6. Super Profit Method – Flow Chart

Average Profit



Normal Profit



Super Profit

↓
× Years' Purchase

↓
GOODWILL

7. Capitalisation Method – Flow Chart

Average Profit

↓
Capitalised Value of Business

↓
Less: Actual Capital Employed

↓
GOODWILL

C. DIAGRAMS (FOR CLEAR UNDERSTANDING)

1. Types of Goodwill Diagram

Goodwill

- |
- |-- Purchased Goodwill
- |-- Inherent Goodwill

- Only **Purchased Goodwill** appears in books.

2. Relationship Diagram: Profit → Goodwill

Profit

↓
Average Profit

↓
Super Profit

↓
Goodwill

3. Capital Employed Diagram

Capital Employed

- |
- |-- Partners' Capital
- |-- Reserves
- |-- Long-term Liabilities
- |-- Less: Fictitious Assets

D. FORMULAS (VERY SCORING)

1. Average Profit Formula

Average Profit

= Total Adjusted Profits ÷ No. of Years

2. Goodwill under Average Profit Method

Goodwill

= Average Profit × Years' Purchase

3. Normal Profit Formula

Normal Profit

= Capital Employed × Normal Rate of Return

4. Super Profit Formula

Super Profit

= Average Profit – Normal Profit

5. Goodwill under Super Profit Method

Goodwill

= Super Profit × Years' Purchase

6. Capitalised Value Formula

Capitalised Value

= Average Profit × 100 / Normal Rate of Return

7. Goodwill under Capitalisation Method

Goodwill

= Capitalised Value – Capital Employed

EXAM ANSWER STRUCTURE (TOPPER STYLE)

For questions like

“Explain Super Profit Method of valuation of goodwill”

Write in order:

- 1 Meaning
- 2 Flow chart
- 3 Formula
- 4 Short numerical illustration

F. MEMORY TRICKS

- Goodwill = Future Benefit
- Super Profit creates goodwill
- Capitalisation = Profit × 100
- No profit → No goodwill
- Goodwill is not a tangible asset



CA VIDHI JAIN - 8949078979

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