MEANING OF KEY TERMS USED IN THIS CHAPTER

1. Goodwill

Goodwill is the value of good name or reputation enjoyed by a firm that places the firm in a position to earn profit more than the normal profit. It is an intangible asset.

2. Purchased Goodwill

Purchased Goodwill means goodwill for which consideration has been paid. Purchased goodwill may be recognised in the books of account.

3. Self-generated Goodwill

Self-generated Goodwill is the goodwill that has been generated by the business because of which it is able to earn higher profit. Self-generated goodwill is not recognised in the books of account.

4. Methods of Valuation of Goodwill

(i) Simple Average Profit Method

It is calculated by taking the average profit for a specified number of years and multiplying it with the number of years of purchase.

Goodwill = Average Profit × No. of Years' Purchase.

(ii) Weighted Average Profit Method

It is calculated by multiplying the profit for each year with the weight assigned to it. The amounts so arrived at are totalled and divided by the total of weights. The weighted average profit is multiplied by the number of years of purchase.

Goodwill = Weighted Average Profit × No. of Years' Purchase.

(iii) Super Profit Method

Super profit is the profit earned by the business that is in excess of the normal profit. Goodwill is determined by multiplying the super profit by the number of years' purchase.

Goodwill = Super Profit × No. of Years' Purchase.

Capitalisation Method

(iv) Capitalisation of Average Profit

Under Capitalisation Method, capitalised value of the business is determined by capitalising the average profit by the normal rate of return. Out of the value so determined, value of net assets is deducted, the balance amount is the value of goodwill.

Goodwill = Capitalised Value of Business – Net Assets.

(v) Capitalisation of Super Profit

Under this method, super profit is capitalised at the normal rate of return.

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

CHAPTER SUMMARY

- **Goodwill:** Goodwill is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in customers. It is one factor which distinguishes an old established business from a new business at its first start.
- **Nature and Characteristics of Goodwill**
  - (i) It is an intangible asset and not a fictitious asset.
  - (ii) It helps to earn more than normal profit.
  - (iii) It is an attractive force which brings in customers to the old place of business.
  - (iv) It is composed of a variety of elements.
  - (v) It is difficult to ascertain the exact value of goodwill.
- **Factors Affecting the Value of Goodwill:** Value of goodwill depends upon the capacity of a business to earn profit in excess of normal profits. Therefore, all such factors which help to increase the profits of a business will also affect the value of goodwill. These factors are: 1. Efficiency of Management, 2. Quality of products, 3. Favourable location, 4. Contracts, 5. Control over raw materials, and 6. Other factors like after sale service, good customer relations, etc.
- **Classification of Goodwill:** Goodwill can be classified into two groups:
  1. *Purchased Goodwill:* Purchased goodwill means goodwill acquired by paying money or money's worth. It may be purchased as an intangible asset but generally it arises when a business is purchased and purchase consideration is more than the value of net assets (*i.e.*, Assets – Liabilities) acquired. The difference amount is the value of purchased goodwill. It may be recognised in the books of account.
  2. *Self-generated Goodwill or Non-purchased Goodwill:* It is an internally generated goodwill which arises from a number of attributes that a running business possessed. It is not recognised in the books.
- **Need for Valuation of Goodwill for Partnership Firms**

  The need for valuation of goodwill arises in the following circumstances:
  - (i) When there is a change in the profit-sharing ratio of existing partners.
  - (ii) When a new partner is admitted.
  - (iii) When a partner retires or dies.
  - (iv) When the firm is sold as a going concern.
  - (v) When two or more firms are amalgamated.
  - (vi) When a partnership firm is converted into a company.
- **Methods of Valuation of Goodwill:**
  1. *Average Profit Method:* Goodwill = Average Profit × No. of Years' Purchase.
  2. *Super Profit Method:* Goodwill = Super Profit × No. of Years' Purchase.
  3. *Capitalisation of Super Profit:* Goodwill = Super Profit × 100/Normal Rate of Return.
  4. *Capitalisation of Average Profit:* Goodwill = Capitalised Value of the Business – Net Assets.
- **Capital Employed:** Capital employed means capital invested in the firm to carry on business.
  - (i) *Liabilities Side Approach:*

    Capital Employed = Capital + Reserves – Goodwill, if any, existing in the books – Fictitious Assets – Non-trade Investments.
  - (ii) *Assets Side Approach:*

    Capital Employed = All Assets (except goodwill, non-trade investments and fictitious assets) – Outside Liabilities.