Valuation & Treatment of Goodwill

1 Marks Questions

1. How does the nature of business affect the value of goodwill of a firm? (All India 2011)

Ans. The firm that produces high value products and has stabilised demand, will be able to earn more profit and more goodwill.

2. What are super profits? (Delhi 2011c)

Ans. Super profit is the excess of actual average profit over the normal profit.
i.e. Super Profit = Actual Profit – Normal Profit

3. How does the factor 'quality of product' affect the goodwill of a firm? (Delhi 2010)

Ans. If the firm enjoys good reputation for its product quality, there will be higher sales and the value of its goodwill will increase.

4. How does the factor 'efficiency of management' affect the goodwill of a firm? (All India 2010)

Ans. When the management of a firm is capable and competent, the firm will earn higher profits therefore the 'efficiency of management' surely will affect or increase the goodwill.

5. How does the factor location affect the goodwill of a firm? (Delhi 2010)

Ans. The value of business will be more, if it is located in a convenient or prominent locality.

6. Define goodwill? (All India 2008)

Ans. Goodwill means the good name or reputation earned by a businessman through his hard work and honesty. This helps the business to earn more profit.

2 Marks Question

7. Explain any two methods for valuation of goodwill. (Delhi 2008C)

Ans. The two methods for valuation of goodwill are as follows
(i) Average Profit Method of Valuation of Goodwill Under average profit method,

goodwill is valued on the basis of simple average or weighted average profits of the firm, multiplied by the number of years' of purchase.
Average Profit =Total Profit (after adjustments) / Number of Years
Goodwill = Average Profit x Number of Years' of Purchase.

(ii) **Valuation of Goodwill by Capitalisation of Super Profit Method** Under this method, goodwill is the capitalised value of super profits. For calculating goodwill, the following steps are followed

(a) Ascertain the average profits based on the past few years' performance.
(b) Calculate normal profit on capital employed by applying normal rate of return.
(c) Calculate super profits by deducting normal profit from average profits.
Goodwill = Super Profit x 100 / Normal Rate of Return

3/4 Marks Questions

8. A business earned average profits of Rs. 1,00,000 during the last few years. The normal rate of return in similar type of business is 10%. The assets of the business were Rs. 10,00,000 and external liabilities was Rs. 1,80,000. Calculate the value of goodwill of the firm by super profit method, if the goodwill is valued at 2. 1/2 years' purchase of super profits.

Ans. Average profits of the firm = ₹ 1,00,000

Capital Employed = Assets – External Liabilities
= 10,00,000 – 1,80,000
= ₹ 8,20,000

$$\text{Normal Profits} = 8,20,000 \times \frac{10}{100} \text{[Capital Employed} \times \text{Normal Rate of Return]}$$
= 82,000

Super Profits = Average Profits – Normal Profits
= 1,00,000 – 82,000
= 18,000

Goodwill = Super Profits × Purchase Year
= 18,000 × 2.5
= 45,000

9. A business has earned average profits of Rs. 1,00,000 during the last few years and the normal rate of return in similar business is 10%. Find out the value of goodwill by
(i) Capitalisation of super profit method.
(ii) Super profit method, if the goodwill is valued at 3 years' purchase of super profit. The assets of the business were Rs. 10,00,000 and its external liabilities

Rs. 1,80,000. (Delhi 2011)

Ans. Actual average profit = ₹ 1,00,000

Normal rate of return = 10%

Total assets = ₹ 10,00,000

External liabilities = ₹ 1,80,000

Capital Employed = Total Assets – External Liabilities

= 10,00,000 – 1,80,000 = ₹ 8,20,000

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

$$= 8,20,000 \times \frac{10}{100} = ₹\ 82,000$$

Super Profit = Average Profit – Normal Profit

= 1,00,000 – 82,000

= ₹ 18,000

(*i*) **Calculation of Goodwill by Capitalisation of Super Profit Method**

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

$$= \frac{18,000 \times 100}{10} = ₹\ 1,80,000$$

(*ii*) **Calculation of Goodwill by Super Profit Method**

Goodwill = Super Profit × Number of Years' as Purchase

= 18,000 × 3 = ₹ 54,000

10. A partnership firm earned net profits during the last 3 years as follows

Year	Net Profit
2007-2008	1,90,000
2008-2009	2,20,000
2010-2011	2,50,000

The capital employed in the firm throughout the above mentioned period has been Rs. 4,00,000. Having regard to the risk involved, 15% is considered to be a fair return on the capital. The remuneration of all the partners during this period is estimated to be Rs. 1,00,000 per annum.

Calculate the value of goodwill on the basis of
(i) 2 years' purchase of super profits earned on average basis during the above mentioned 3 years and
(ii) By capitalisation method.

Ans. 3 years' total profit = 1,90,000 + 2,20,000 + 2,50,000 = ₹ 6,60,000

Average profit = $\frac{6,60,000}{3}$ = ₹ 2,20,000

(–) Remuneration to partners = ₹ 1,00,000

Actual average profit = ₹ 1,20,000

Capital employed = ₹ 4,00,000

Normal rate of return = 15%

$$\text{Normal profit} = 4,00,000 \times \frac{15}{100} = ₹\ 60,000$$

$$\text{Super Profit} = \text{Actual Average Profit} - \text{Normal Profit}$$
$$= 1,20,000 - 60,000 = ₹\ 60,000$$

(*i*) Goodwill = Super Profit × Number of Years' Purchase

$$= 60,000 \times 2 = ₹1,20,000$$

(*ii*) Capitalised Value of Goodwill $= \frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$

$$= \frac{60,000}{15} \times 100 = ₹\ 4,00,000$$