2. GOODWILL

2.1 Goodwill - Meaning

1. Goodwill is the value of reputation of a Firm in respect of profits expected in future over and above the normal rate of profits earned by similar Firms in the same locality.
2. Goodwill is the benefit and advantage of the good name, reputation and connections of a business Firm. It is the attractive force which brings in customers, and enhances the revenues of the Firm.

2.2 Features of Goodwill

1. Goodwill is an **Intangible Asset**, i.e. cannot be seen and felt. (However, it is not a Fictitious Asset, like Discount on Issue of Debentures, Misc. Expenditure not written off or adjusted, etc.)
2. Goodwill helps a Firm to earn **more profits** than other Firms in the same line of business. Strictly, there is no Goodwill, if the Firm is able to earn the same profits as any other Firm.
3. Goodwill **cannot have an existence separate** from that of the Business Firm. Hence, Goodwill as such cannot be sold, it can be sold when the entire Business Firm is sold.
4. Value of Goodwill is **subjective**. It depends upon the purpose of valuation, and judgement of the Valuer.
5. Value of Goodwill is **not constant** throughout the life of the business. It fluctuates with the changes in the fortunes of the Firm.

2.3 Factors that create / affect the value of Goodwill

Goodwill is subject to a variety of factors, a few are as below –

1. Efficient Management,
2. Quality of Firm's Products and Services,
3. Locational and other advantages,
4. Patents, Copyrights, Intellectual Property Rights, and similar advantages,
5. Favourable Contracts and bargaining power with Suppliers, Customers, etc.

2.4 Types of Goodwill

A. Purchased Goodwill	B. Self–Generated Goodwill
1. **Purchased Goodwill** arises when a business is purchased, and the consideration paid therefor is more than the value of Net Assets taken over.	1. It refers to **internally generated goodwill**, that arises to the special advantages possessed by the Firm. (See **Q.No.3**)
2. Purchased Goodwill = Purchase Consideration on takeover of business **Less** Net Assets taken over.	2. Internally Generated Goodwill is **not recorded** in the books of account, since Accounting Standard – 10 issued by ICAI specifically provides so.
3. Such Purchased Goodwill is recorded in the books of accounts, and is **shown** in the **Balance Sheet**.	3. Internally Generated Goodwill is valued in specific situations listed below. (See **Q.No.5**)
4. The Firm may **write off** Purchased Goodwill over a period of time.	

2.5 Situations, which may involve a valuation of Goodwill in case of Partnership Firms

The following are the situations warranting Valuation of Goodwill in case of Partnership Firms –

1. Change in Profit Sharing Ratio amongst the Partners,
2. Admission of a new Partner,
3. Retirement of a Partner,
4. Death of a Partner,
5. Dissolution of the Partnership,
6. Amalgamation of two or more Firms, and
7. Sale of the Firm (to a Company).

2.6 Various methods of valuation of Goodwill

Methods of Valuing Goodwill

- **Average Profits Method**
- **Super Profits Method**
- **Discounting or Annuity Method**
- **Capitalisation Method**

The procedures for calculation are explained below –

1. Average Profits Method

Step	Procedure
1	Compute the Profits of the previous financial years, say, past 5 years. [**Note:** Such profits should be adjusted for items like Salary to Partners & IOC not provided, Abnormal Losses & Gains, etc.]
2	Compute **Average Profits** = Total Profits for the past period ÷ Number of years. [**Note:** If there is a noticeable trend increase in the amount of profits, Weighted Average Profits may be used, instead of Simple Average as specified above. In such case, more weightage is given to the profits of the recent years than that of the earlier years.]
3	Compute **Goodwill** = **Average Profits × Number of years purchase.**

2. Super Profits Method

Step	Procedure
1	Compute the Profits of the previous financial years, say, past 5 years. [**Note:** Such profits should be adjusted for items like Salary to Partners & IOC not provided, Abnormal Losses & Gains, etc.]
2	Compute **Average Profits** = Total Profits for the past period ÷ Number of years.
3	Compute **Normal Profits** = Firm's Capital Employed × Normal Rate of Return. [**Note:** Capital Employed = Tangible Fixed Assets + Current Assets – Current Liabilities.]
4	Compute **Super Profits** = Average Profit **Less** Normal Profit = **Step 2 – Step 3.**
5	Compute **Goodwill** = **Super Profits × Number of years purchase.**

Note: This method is based on the principle that Goodwill helps the business to earn something more than the normal profits earned by other businesses. Hence, Super Profits is used for Goodwill Valuation.

3. Discounting or Annuity Method

Step	Procedure
1	Compute **Super Profits** of the Firm. (as per Super Profits Method given above).
2	Ascertain the number of years for which such Super Profits are maintainable, and obtain the **Present Value** (PV) of Re.1 for each such year. [**Note:** PV can be obtained from the Annuity Tables, or by using the formula $[1\div(1+R)]^N$, where R = Rate of Interest, and N = N^{th} year.]
3	Compute **Goodwill** = Total of (Super Profits × PV for each year).

Note: This is a refined form of Super Profit Method wherein the Time Value of Money is also considered to determine Goodwill. The Super Profits which are to be earned in future years are discounted to their Present Value and Goodwill is determined based on such discounted value.

4. Capitalisation Method

Step	Procedure
1	Compute the Profits of the previous financial years, say, past 5 years. [**Note:** Such profits should be adjusted for items like Salary to Partners & IOC not provided, Abnormal Losses & Gains, etc.]
2	Compute **Average Profits** = Total Profits for the past period ÷ Number of years.
3	Compute **Expected or Normal Capital Employed** = Average Profits ÷ Normal Rate of Return.
4	Compute **Actual Capital Employed** in the Firm. [**Note:** Capital Employed = Tangible Fixed Assets + Current Assets – Current Liabilities.]
5	Compute **Goodwill** = Normal Capital Employed **Less** Actual Capital Employed = Step 3 – Step 4.

Note: This is a modification of the Super Profits method.

2.7 (1) Sacrificing Ratio, and (2) Gaining Ratio

A change in profit–sharing ratio of Partners will mean that one or more existing Partners will surrender a part of their share in profits, in favour of one or more of existing or new Partners. Such change in PSR may arise – (a) in case of admission of new Partner, (b) in case of retirement / death of a Partner, or (c) when Partners mutually agree for change in PSR.

Sacrifice	Gain
Partners whose shares in profit have decreased as a result of change in PSR, are known as **Sacrificing Partners.**	Partners whose shares in profit have increased as a result of change in PSR, are known as **Gaining Partners.**
The ratio in which Partners have agreed to reduce their profits in favour of the other Partner(s) is called **Sacrifice Ratio** or **Sacrificing Ratio.**	The ratio in which Partners have agreed to gain their profits from the other Partner(s) is called **Gain Ratio** or **Gaining Ratio.**
Sacrifice Ratio = Old Ratio **less** New Ratio.	**Gain Ratio** = New Ratio **less** Old Ratio.

2.8 Accounting treatment of Goodwill in case of change in PSR by agreement (i.e. without Admission / Retirement / Death)

Accounting Issue involved	Journal Entry
1. Writing off Goodwill existing in books **(See Note)**	All Partner's Capital A/c (individually) Dr. (in **Old Ratio**) To Goodwill A/c
2. Adjusting Goodwill on change in PSR	Gaining Partners' Capital A/c (individually) Dr. (in **Gain Ratio**) To Sacrificing Partners' Capital A/c (in **Sacrifice Ratio**)

Note: As per AS – 10, only Purchased Goodwill should be shown in the books of accounts. Other Goodwill value, if any in the Balance Sheet, should be written off from the books of accounts.

2.9 Inferred Goodwill or Hidden Goodwill

1. **Meaning:** Inferred Goodwill is said to arise when the Fixed Capitals are in the Profit and Loss Sharing Ratio and the new partner brings in more than proportionate share towards Capital. The Goodwill is arrived by considering the Surplus Fixed Capital brought in by the New Partner and working back to arrive at the Firm's Goodwill.

2. **Fixed Capitals:** Inferred Goodwill can be computed only if the Fixed Capitals of the Partners are in Profit / Loss Sharing Ratio.

3. **Example:** A and B are Partners with equal partners with Fixed Capitals of ₹1,00,000 each. C is the admitted as the new partner with one fifth share in the profits / losses. He is required to bring in ₹ 50,000. Total Capital of the Firm before admission is ₹ 2,00,000. Therefore, amount of capital required to be brought in by C is ₹ 40,000 (i.e. ₹ 2,00,000 ×1/5). Amount brought in by C is ₹ 50,000. Excess Capital brought in by C towards Goodwill is ₹ 10,000 for 1/5th Share in the Profits. Therefore, Goodwill of the Firm is ₹ 10,000 ÷ 1/5th Share = ₹ 50,000.

Illustration 1: Average Profits Method

Amar purchased Bikram's business with effect from 1st January 2009. It was agreed that the Firm's Goodwill is to be valued at 2 years purchase of Normal Average Profits of the last 3 years. The profits of Bikram's business for the last three years are as follows –

Year	Amount (in)
2006	₹ 80,000 (including an Abnormal Gain of ₹ 10,000)
2007	₹ 1,00,000 (after charging an Abnormal Loss of ₹ 20,000)
2008	₹ 90,000 (excluding ₹ 10,000 as insurance premium on Firm's Property, now to be insured)

Calculate the value of Firm's Goodwill.

Solution:

Particulars	Year 2006	Year 2007	Year 2008	Total
1. Normal Average Profits	80,000 – 10,000 = ₹ 70,000	1,00,000+20,000 = ₹ 1,20,000	90,000 – 10,000 = ₹ 80,000	₹ 2,70,000
2. Average Profits of the above = ₹ 2,70,000 ÷ 3 =				₹ 90,000
3. Goodwill = 2 years purchase of 3 years Normal Average Profit = ₹ 90,000 × 2 =				₹ 1,80,000

Illustration 2: Super Profits Method and Annuity Method

A Firm earned Net Profits during the last three years as follows –

Year	I	II	III
Profit	₹ 18,000	₹ 20,000	₹ 22,000

The Capital Investment of the Firm is ₹ 60,000. A fair return on the capital having regard to the risk involved is 10%. Compute the value of Goodwill based on three years purchase of the Super Profits for the last three years. What will be the value of Goodwill if the future cash flows of the next three years are discounted at 8% rate?

1. Average Profits of last three years = $\frac{18,000+20,000+22,000}{3}$ = ₹ 20,000
2. Normal Profits = Capital Employed × Normal Rate of Return = ₹ 60,000 × 10% = ₹ 6,000
3. Super Profit = Average Profits – Normal Profits = 20,000 – 6,000 = ₹ 14,000
4. **Goodwill** = Super Profits × No. of years Purchase = ₹ 14,000 × 3 = ₹ **42,000**
5. **Goodwill** under Discounting Method is calculated as under –

Year	Super Profits	Present Value Factor 8%	Discounted Value
1	₹ 14,000	0.9259	₹ 12,963
2	₹ 14,000	0.8573	₹ 12,002
3	₹ 14,000	0.7938	₹ 11,113
		Value of Goodwill =	**₹ 36,078**

Illustration 3: Capitalisation Method

The Average Profit of the Firm is ₹ 1,50,000. The Total Tangible Assets in the Firm are ₹ 14,00,000 and Outside Liabilities are ₹ 4,00,000. In the same type of business, the Normal Rate of Return is 10% of the Capital Employed. Calculate the Value of Goodwill by Capitalisation of Super Profits Method.

Solution:

1. Average Profits = ₹ 1,50,000 (given)
2. Normal Capital Employed = Average Profits ÷ Normal Rate of Return = 1,50,000 ÷ 10% = ₹ 15,00,000
3. Actual Capital Employed = Total Tangible Assets – Outside Liab. = 14,00,000 – 4,00,000 = ₹ 10,00,000
4. Goodwill = Normal Capital Employed **Less** Actual Capital Employed = (2) – (3) = ₹ **5,00,000.**

Alternative Method of Computation:

- Normal Profit = Capital Employed × Normal Rate of Return = 10,00,000 × 10% = ₹ 1,00,000
- Super Profit = Average Profits – Normal Profits = 1,50,000 – 1,00,000 = ₹ 50,000
- Goodwill = $\frac{\text{Super Profits} \times 100}{\text{Normal Rate of Return}} = \frac{50{,}000 \times 100}{10}$ = ₹ **5,00,000**

Illustration 4: Change in PSR and Treatment of Goodwill

A, B, C and D were sharing profits equally. On 1st January, they agreed that future profits will be shared as 4:3:2:1. Upon change in PSR, the Goodwill of the Firm is valued at ₹ 4,00,000. What will be the adjustment required in the Capitals of the Partners, to record the change in PSR? What will be the effect of ₹ 1,00,000 Goodwill already appearing in the Firm's books?

Solution:

Particulars	**A**	**B**	**C**	**D**
1. Old PSR	$1/4^{th}$	$1/4^{th}$	$1/4^{th}$	$1/4^{th}$
2. New PSR	$4/10^{th}$	$3/10^{th}$	$2/10^{th}$	$1/10^{th}$
3. Change in PSR	1/4 – 4/10 = –6/40 (i.e. Gain)	1/4 – 3/10 = –2/40 (i.e. Gain)	1/4 – 2/10 = –2/40 (i.e. Sacrifice)	1/4 – 1/10 = –6/40 (i.e. Sacrifice)
4. G/W Adjustment	6/40 × 4,00,000 = ₹ 60,000 Dr.	2/40 × 4,00,000 = ₹ 20,000 Cr.	2/40 × 4,00,000 = ₹ 20,000 Cr.	6/40 × 4,00,000 = ₹ 60,000 Cr.

Note: If Old PSR < New PSR, the Partner has gained. If Old PSR > New PSR, the Partner makes a sacrifice.

5. **Journal Entries**

	Particulars		**Dr.**	**Cr.**
1.	A's Capital A/c	Dr.	60,000	
	B's Capital A/c	Dr.	20,000	
	To C's Capital A/c			20,000
	To D's Capital A/c			60,000
	(Being adjustment for Goodwill, on change in PSR)			
2.	A's Capital A/c	Dr.	25,000	
	B's Capital A/c	Dr.	25,000	
	C's Capital A/c	Dr.	25,000	
	D's Capital A/c	Dr.	25,000	
	To Goodwill A/c			
	(Being G/w appearing in books, written off in Old Ratio)			

Illustration 5: Capital Ratio, Change in PSR and Goodwill Adjustment

Ashwin and Balu had ₹ 10,000 and ₹ 6,000 as Capitals respectively 1st April 2008. They agree to share profits in the capital ratio. They have following transactions during the year –

	Capital introduced		Capital withdrawn	
	Ashwin	Balu	Ashwin	Balu
1st June	₹ 2,000	–	–	–
1st July	–	₹ 7,000	₹ 3,000	–
1st September	₹ 4,000	–	–	₹ 6,000
31st December	–	₹ 8,000	₹ 8,000	–

- **Determine the ratio in which the Partners will share the profits as at present.**
- **What will be the adjustment required if the Partners decide to change the Profit Sharing Ratio to 2:3, with effect from 1st April 2009, the agreed value of Goodwill being ₹ 60,000?**

Solution:

1.Total Capital Employed by Ashwin:

Date	Capital	No. of months Capital is used in business	Product
01.04.2008	₹ 10,000	2	₹ 20,000
01.06.2008	(10,000 + 2,000) = ₹ 12,000	1	₹ 12,000
01.07.2008	(12,000 – 3,000) = ₹ 9,000	2	₹ 18,000
01.09.2008	(9,000 + 4,000) = ₹ 13,000	4	₹ 52,000
01.01.2009	(13,000 – 8,000) = ₹ 5,000	3	₹ 15,000
	Total	**12**	**₹ 1,17,000**

2. Total Capital employed by Balu:

Date	Capital	No. of months Capital is used in business	Product
01.04.2008	₹ 6,000	3	₹ 18,000
01.07.2008	(6,000 + 7,000) = ₹ 13,000	2	₹ 26,000
01.09.2008	(13,000 – 6,000) = ₹ 7,000	4	₹ 28,000
01.01.2009	(7,000 + 8,000) = ₹ 15,000	3	₹ 45,000
	Total	**12**	**₹ 1,17,000**

3. So, **Present PSR** = Capital Ratio between Ashwin and Balu = 117 : 117, i.e. 1:1 (or Equal Partners).

4. Computation of Gain / Sacrifice

Particulars	Ashwin	Balu
1. Old PSR	½	½
2. New PSR	2/5th	3/5th
3. Change in PSR	1/2 – 2/5 = 1/10 (i.e. Sacrifice)	1/2 – 3/5 = –1/10 (i.e. Gain)
4. G/W Adjustment	1/10 × ₹ 60,000 = ₹ 6,000 Cr.	1/10 × ₹ 60,000 = ₹ 6,000 Dr.
5. Journal Entry for G/w Adjt	Balu's Capital A/c Dr. ₹ 6,000 To Ashwin's Capital A/c ₹ 6,000	

Illustration 6: Change in PSR and agreed Adjustments

The Balance Sheet of X and Y, who are sharing profits in the ratio 2:1, as on 1st April is given below –

Liabilities		₹	Assets	₹
Capital Accounts:			**Land and Buildings**	**29,000**
X	**30,000**		**Furniture**	**8,000**
Y	**20,000**	**50,000**	**Stock**	**24,000**
Reserve		**15,000**	**Sundry Debtors**	**15,000**
Sundry Creditors		**25,000**	**Cash and Bank**	**14,000**
Total		**90,000**	**Total**	**90,000**

On the above date, the Partners changed their Profit–Sharing Ratio to 3:2. Following were agreed –

- **Value of Land and Buildings will be ₹ 50,000.**
- **Reserve to be maintained at ₹ 30,000.**
- **Total Capital of the Firm will be ₹ 60,000, which will be shared by the Partners in their new profit–sharing ratio.**

From the above, prepare the Partners' Capital Accounts and the revised Balance Sheet.

Solution:

1. **Treatment of Reserves:**
   (a) Reserve of ₹ 15,000 appearing in Balance Sheet before change in Profit Sharing Ratio will be distributed between the Partners in their Old Ratio 2:1.
   (b) Newly required Reserve of ₹ 30,000 will be created by debiting the Partners' Capital A/cs in New Ratio, i.e. 3:2. So, X's Share = ₹ 30,000 × 3/5 = ₹ 18,000, Y's Share = ₹ 30,000 × 2/5 = ₹ 12,000.

2. Partners' Capital Accounts

Particulars	X	Y	Particulars	X	Y
To Reserve A/c (**Note 1**)	18,000	12,000	By balance b/d	30,000	20,000
To balance c/d (Reqd Capital)	36,000	24,000	By Reserve A/c (**Note 1**)	10,000	5,000
(₹ 60,000 as 3 : 2)			By Land and Buildings A/c	14,000	7,000
			By Cash A/c (bal. figure)	–	4,000
Total	**54,000**	**36,000**	**Total**	**54,000**	**36,000**

Note: Gain on Revaluation of Land & Buildings ₹ 50,000 – ₹ 29,000 = ₹ 21,000, credited to Partners' Capital A/c in Old Ratio.

3. Balance Sheet of X and Y as on 1st April (after change in PSR)

Liabilities	₹	₹	Assets	₹
Capital Accounts:			Land and Buildings (revalued amount)	50,000
X	36,000		Furniture	8,000
Y	24,000	60,000	Stock	24,000
Reserve		30,000	Sundry Debtors	15,000
Sundry Creditors		25,000	Cash and Bank (₹ 14,000 + ₹ 4,000)	18,000
Total		**1,15,000**	**Total**	**1,15,000**