Q3. Explain various methods of valuation of goodwill.
Solution: Four methods of valuation of goodwill:

1. Average Profit Method: Goodwill is calculated on the average basis of the profits of past few years. The formula for calculating goodwill is

$$\text{Goodwill} = \text{Average Profit} \times \text{No. of Years Purchase}$$

$$\text{Average Profit} = \frac{\text{Total Profit of Past Given Years}}{\text{Number of Years}}$$

Number of Years Purchase implies number of years for which the firm expects to earn the same amount of profits. Steps to calculate goodwill by the average profit method:
Step 1: Ascertain the total profit of past given years
Step 2: Add Abnormal losses like loss by fire and theft
Step 3: Add All normal incomes if not added previously
Step 4: Less All non-business incomes and all abnormal gains and incomes like speculation and lottery
Step 5: Less All normal expenses if not deducted previously
Step 6: Calculate Average Profit, by dividing the total profit ascertained in Step 5 by number of years
Step 7: Multiply the Average Profit to the Number of Years' Purchases to calculate the Value of Goodwill

Example:
The profits for last 5 years are Rs 2,00,000, 6,00,000, (4,00,000), 10,00,000, 16,00,000. Calculate goodwill on the basis of 4 years purchase.

$$\text{Average Profit} = \frac{2,00,000 + 6,00,000 + 10,00,000 + 16,00,000 - 4,00,000}{5}$$

$$= \frac{30,00,000}{5} = \text{Rs } 6,00,000$$

$$\text{Goodwill} = 6,00,000 \times 4\text{years} = \text{Rs } 24,00,000$$

2. Weight Average Method: Weights are assigned for each year's profit in a manner where higher weights are assigned to the recent year's profit and lower weights are assigned to the past year's profits. The products of the profits and the weights are added and divided by the total weights to calculate Weighted Average Profits. The formula for calculating goodwill by this method is

$$\text{Weighted Average Profit} = \frac{\text{Total Products of Profits}}{\text{Total of Weighted}}$$

Steps to Calculate Goodwill by Weight Average Method:

Step 1: Assign weights to ever year. More recent years with higher weight
Step 2: Multiply the weights with its corresponding year's profits
Step 3: Calculate the total of the products
Step 4: Divide the total of the product by the total of the weights to calculate Weighted Average Profit
Step 5: Multiply the Weighted Average Profit by the number of years purchase

Example:
The profits for the last 5 years are Rs 2,00,000, Rs 6,00,000, Rs (4,00,000), Rs 10,00,000, Rs 16,00,000
Calculate goodwill on the basis of 4 years purchase.

Profit/Loss	Weights	Product
2,00,000	1	2,00,000 × 1 = 2,00,000
6,00,000	2	6,00,000 × 2 = 12,00,000
(4,00,000)	3	(4,00,000) × 3 = (12,00,000)
10,00,000	4	10,00,000 × 4 = 40,00,000
16,00,000	5	16,00,000 × 5 = 80,00,000
Total	**15**	**1,22,00,000**

$$\text{Weighted Average Profit} = \frac{1,22,00,000}{15} = \text{Rs } 8,13,334$$

$$\text{Goodwill} = 8,13,334 \times 4 = \text{Rs } 32,53,336$$

3. Super Profit Method: Here, goodwill is calculated on the basis of excess profit earned by a firm over and above the normal profit earned by its counterparts in the same industry. The excess profit over the normal profit is termed Super Normal Profit.
Steps to Calculate Goodwill by Super Profit Method:
Step 1: Calculate Average Profit
Step 2: Calculate Average Capital Employed as

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

Step 4: Calculate Super Normal Profit by the formula:
Super Normal Profit = Average Profit - Normal Profit
Step 5: Multiply the Super Normal Profit by the Number of Years Purchase to calculate goodwill.

4. Capitalisation Method: There are two methods of capitalisation:
a. By capitalisation of Average Profit
b. By capitalisation of Super Profit
a. Capitalisation of Average Profit

Step 1: Calculate Average Profit
Step 2: Calculate Capitalised Value of Average Profit by the following formula:

$$\text{Capitalised value of Average Profit} = \text{AverageProfit} \times \frac{100}{\text{Normal Rate of Return}}$$

Step 3: Ascertain Actual Capital Employed

Step 4: Deduct Actual Capital Employed from Capitalised Average Profit to calculate goodwill.

Goodwill = Capitalised Average Profit - Actual Capital Employed
b. Capitalisation of Super Profit
Step 1: Calculate the Capital Employed
Step 2: Calculate Normal Profit by the following formula:

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

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