CHAPTER

2

Goodwill: Nature and Valuation

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 higher 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.

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

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 on 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.

Solved Questions

Illustration 1.

Brick, Sand and Cement were in partnership sharing profits and losses in the ratio of 5 : 3 : 2. They decide to take Lime into partnership from 1st April, 2026. For this purpose, Goodwill is to be valued at 80% of the average annual profits of the previous three or four years, whichever is higher.

The profits were:	₹
Year ended 31st March, 2026	48,000
Year ended 31st March, 2025	30,000
Year ended 31st March, 2024	31,500
Year ended 31st March, 2023	45,000

Calculate the value of Goodwill.

Solution:

CALCULATION OF AVERAGE PROFIT

Based on 3 years' profits	₹	Based on 4 years' profits	₹
Year ended 31st March, 2026	48,000	Year ended 31st March, 2026	48,000
Year ended on 31st March, 2025	30,000	Year ended 31st March, 2025	30,000
Year ended on 31st March, 2024	31,500	Year ended 31st March, 2024	31,500
		Year ended 31st March, 2023	45,000
	1,09,500		1,54,500
Average Profit = ₹ 1,09,500/3 = ₹ 36,500		**Average Profit = ₹ 1,54,500/4 = ₹ 38,625**	

Four years' average profit is higher than the three years' average profit. Therefore, the value of Goodwill will be 80% of ₹ 38,625 = ₹ 30,900.

Illustration 2.

XY & Co., a partnership firm, intends to estimate the value of its Goodwill on the basis of three years' purchase of super profit of the firm. The capital employed in the firm is ₹ 1,50,000 and the normal rate of return is 20%. Profits for the last four years were:

2022–23—₹ 35,000 2023–24—₹ 38,000
2024–25—₹ 42,000 2025–26—₹ 45,000

Solution:

Capital Employed = ₹ 1,50,000
Normal Rate of Return = 20%
∴ Normal Profit = ₹ 1,50,000 × 20/100 = ₹ 30,000

$$\text{Average Profit} = \frac{₹\ 35,000 + ₹\ 38,000 + ₹\ 42,000 + ₹\ 45,000}{4}$$
$$= ₹\ 40,000.$$

Super Profit = Average Profit – Normal Profit
= ₹ 40,000 – ₹ 30,000 = ₹ 10,000
Goodwill = Super Profit × No. of Years' Purchase
= ₹ 10,000 × 3 = ₹ 30,000.

Illustration 3.

On 1st April, 2026, an existing firm had assets of ₹ 75,000 including cash of ₹ 5,000. Its creditors amounted to ₹ 5,000 on that date. The firm had a Reserve Fund of ₹ 10,000 while Partners' Capital Accounts showed a balance of ₹ 60,000. If the normal rate of return is 20% and the Goodwill of the firm is valued at ₹ 24,000, at four years' purchase of super profit, find the average profit per year of the existing firm.

Solution:

Goodwill is valued at four years' purchase of Super Profit, which is ₹ 24,000.

Therefore, Goodwill = Super Profit × 4

or ₹ 24,000 = Super Profit × 4

or Super Profit = ₹ 24,000/4 = ₹ 6,000

Again, Normal Profit = Capital Employed × Normal Rate of Return/100

= (Capital + Reserve) × 20/100

= (₹ 60,000 + ₹ 10,000) × 20/100 = ₹ 14,000.

Super Profits are the excess of average profit over normal profit.

Therefore, Super Profit = Average Profit – Normal Profit

or ₹ 6,000 = Average Profit – ₹ 14,000

or Average Profit = ₹ 14,000 + ₹ 6,000 = ₹ 20,000.

Illustration 4.

X and *Y* are partners sharing profits equally. They decide to admit *Z* for an equal share. For this purpose, the Goodwill is to be valued on the basis of capitalisation of average profit. The net assets of the firm are ₹ 3,20,000. Average maintainable profit of the firm is ₹ 45,000. The normal rate of return may be taken as 12% p.a. Calculate the Value of Goodwill according to Capitalisation of Average Profit Method.

Solution:

$$\text{Capitalised Value of the Firm} = \frac{\text{Average Maintainable Profit}}{\text{Normal Rate of Return}} \times 100$$

$$= \frac{₹\ 45{,}000}{12} \times 100 = ₹\ 3{,}75{,}000.$$

Goodwill = Capitalised Value of the Firm – Net Assets

= ₹ 3,75,000 – ₹ 3,20,000 = ₹ 55,000.

Illustration 5.

A firm earns ₹ 80,000 as its average profits. The rate of normal profit being 10%, the assets of the firm amounted to ₹ 10,00,000 and liabilities are ₹ 4,40,000. Calculate the value of Goodwill according to Capitalisation of Average Profit Method.

Solution:

$$\text{Capitalised Value of the Firm} = \frac{₹\ 80{,}000 \times 100}{10} = ₹\ 8{,}00{,}000.$$

Net Assets = Total Assets – Outside Liabilities

= ₹ 10,00,000 – ₹ 4,40,000 = ₹ 5,60,000

Goodwill = Capitalised Value of the Firm – Net Assets

= ₹ 8,00,000 – ₹ 5,60,000 = ₹ 2,40,000.

Illustration 6.

A firm earns a profit of ₹ 2,00,000. The Normal Rate of Return in a similar type of business is 10%. The value of total assets (excluding Goodwill) and total outsiders' liabilities as on the date of valuation of Goodwill are ₹ 22,00,000 and ₹ 5,60,000 respectively. Calculate the value of Goodwill according to Capitalisation of Super Profit Method.

Solution:

Average Profit (Given) = ₹ 2,00,000

Normal Profit = (₹ 22,00,000 – ₹ 5,60,000) × 10/100 = ₹ 1,64,000

Super Profit = ₹ 2,00,000 – ₹ 1,64,000 = ₹ 36,000

Goodwill = ₹ 36,000 × 100/10 = ₹ 3,60,000.

Illustration 7 (*Average Profit Method when Adjustments are Made*).

A purchased *B*'s business with effect from 1st April, 2026. It was agreed that the firm's goodwill is to be valued at two years' purchase of average normal profit of the last three years. The profits of *B*'s business for the last three years were:

2023–24 — ₹ 1,00,000 (including an abnormal gain of ₹ 10,000).

2024–25 — ₹ 1,10,000 (after charging an abnormal loss of ₹ 20,000).

2025–26 — ₹ 80,000.

Calculate value of the firm's goodwill.

Solution:

	Normal Profits	₹
Profit for 2023–24	(₹ 1,00,000 – ₹ 10,000)	90,000
Profit for 2024–25	(₹ 1,10,000 + ₹ 20,000)	1,30,000
Profit for 2025–26	(₹ 80,000)	80,000
Total profits for last three years		3,00,000

$$\text{Average Normal Profit} = \frac{₹\ 3,00,000}{3} = ₹\ 1,00,000$$

Goodwill = 2 years' purchase of 3 years' average normal profit

= ₹ 1,00,000 × 2 = ₹ 2,00,000.

Illustration 8.

Bharat and Bhushan are partners in a retail business. Balances in Capital and Current Accounts as on 31st March, 2026 were:

	Capital Account	Current Account
Bharat	₹ 2,00,000	₹ 50,000
Bhushan	₹ 2,40,000	₹ 10,000 (Dr.)

The firm earned an average profit of ₹ 90,000. If the normal rate of return is 10%, find the value of goodwill.

Solution:

$$\text{Capitalised Value of the Business} = \frac{\text{Average Profit} \times 100}{\text{Normal Rate of Return}}$$

$$= ₹\,90,000 \times \frac{100}{10} = ₹\,9,00,000$$

$$\text{Capital Employed} = ₹\,2,00,000 + ₹\,2,40,000 + ₹\,50,000 - ₹\,10,000 = ₹\,4,80,000$$

$$\text{Goodwill} = ₹\,9,00,000 - ₹\,4,80,000 = ₹\,4,20,000.$$

Illustration 9.

From the following information, calculate value of goodwill of M/s. Amit and Sumit:

(i) At three years' purchase of Average Profit.

(ii) At the two years' purchase of Super Profit.

(iii) On the basis of Capitalisation of Super Profit.

(iv) On the basis of Capitalisation of Average Profit.

Information:

(a) Average Capital Employed—₹ 6,00,000.

(b) Net Profit/Loss of the firm for the past three years: 2024—₹ 2,00,000 (Profit); 2025—₹ 1,00,000 (Loss); 2026—₹ 2,30,000 (Profit).

(c) Normal Rate of Return on capital is 12%.

(d) Remuneration of each partner ₹ 30,000 per annum to be considered as a charge against profit.

(e) Assets—₹ 6,50,000; Partners' Capital—₹ 6,00,000.

Solution:

(i) *Calculation of Goodwill at three years' purchase of Average Profit:*

$$\text{Average Profit} = \frac{₹\,2,00,000 - ₹\,1,00,000 + ₹\,2,30,000}{3} = ₹\,1,10,000$$

$$\text{Average Normal Profit} = \text{Average Profit} - \text{Partners' Remuneration}$$

$$= ₹\,1,10,000 - ₹\,60,000 = ₹\,50,000$$

$$\text{Value of Goodwill} = \text{Average Normal Profit} \times \text{Number of Years' Purchase}$$

$$= ₹\,50,000 \times 3 = ₹\,1,50,000.$$

(ii) *Calculation of Goodwill at three years' purchase of Super Profit:*

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

$$= ₹\,6,00,000 \times 12/100 = ₹\,72,000$$

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

$$= ₹\,50,000 - ₹\,72,000 = (₹\,22,000)$$

Since the firm does not have Super Profit, the value of goodwill is nil.

(iii) *On the basis of Capitalisation of Super Profit:*

The firm does not have Super Profit. Hence, the value of goodwill is nil.

(iv) *On the basis of Capitalisation of Average Profit:*

$$\text{Goodwill} = \text{Total Capitalised Value of Business} - \text{Net Assets}$$

$$\text{Total Capitalised Value of Business} = \frac{\text{Average Normal Profit} \times 100}{\text{Normal Rate of Return}}$$

$$= \frac{₹\ 50{,}000 \times 100}{12} = ₹\ 4{,}16{,}666 \textit{ or } ₹\ 4{,}16{,}667 \text{ (say)}$$

$$\text{Net Assets} = \text{Total Assets} - \text{Outside Liabilities}$$

$$\text{Outside Liabilities} = \text{Total Assets} - \text{Partners' Capital}$$

$$= ₹\ 6{,}50{,}000 - ₹\ 6{,}00{,}000 = ₹\ 50{,}000$$

$$\therefore \quad \text{Net Assets} = ₹\ 6{,}50{,}000 - ₹\ 50{,}000 = ₹\ 6{,}00{,}000$$

$$\text{Value of Goodwill} = ₹\ 4{,}16{,}667 - ₹\ 6{,}00{,}000 = (₹\ 1{,}83{,}333)$$

The value of goodwill is nil since capitalised value of business is less than the net assets.

Illustration 10 (*Weighted Average Profit when Past Adjustments are Made*).

Akhil and Nikhil are partners sharing profits equally. They admitted Dinesh into partnership. It was agreed to value goodwill at three years' purchase following Weighted Average Profit Method on the basis of past five years' profits. Weights assigned to each year would be—years ended 31st March, 2022–1, 2023–2, 2024–3, 2025–4 and 2026–5.

The profits for these years were—₹ 90,000, ₹ 80,000, ₹ 1,25,000, ₹ 1,50,000 and ₹ 1,75,000 respectively.

Verification of books of account revealed the following:

1. There was an abnormal loss of ₹ 15,000 during the year ended 31st March, 2022.
2. There was an abnormal gain of ₹ 10,000 during the year ended 31st March, 2024.
3. Closing Stock as on 31st March, 2025 was overvalued by ₹ 15,000.

Calculate value of goodwill.

Solution:

1. CALCULATION OF NORMAL PROFIT

Year Ended	Profit (₹)	Adjustment (₹)	Normal Profit (₹)
31st March, 2022	90,000	15,000	1,05,000
31st March, 2023	80,000	...	80,000
31st March, 2024	1,25,000	(10,000)	1,15,000
31st March, 2025	1,50,000	(15,000)*	1,35,000
31st March, 2026	1,75,000	15,000*	1,90,000

*Closing Stock being overvalued on 31st March, 2025 means that profit for the year is shown at higher amount. It has effect on the profit for the next year. Profit for next year is shown at lower amount as Closing Stock of previous year is carried forward as Opening Stock of next year.

2. CALCULATION OF WEIGHTED PROFIT

Year Ended	Profit (₹)	Weights	Weighted Profit (₹)
31st March, 2022	1,05,000	1	1,05,000
31st March, 2023	80,000	2	1,60,000
31st March, 2024	1,15,000	3	3,45,000
31st March, 2025	1,35,000	4	5,40,000
31st March, 2026	1,90,000	5	9,50,000
		15	21,00,000

$$\text{Weighted Average Profit} = \frac{\text{Total of Weighted Profit}}{\text{Total of Weights}} = \frac{₹\ 21,00,000}{15} = ₹\ 1,40,000$$

Number of Years' Purchase = 3

∴ Value of Goodwill = Weighted Average Profit × Number of Years' Purchase

= ₹ 1,40,000 × 3 = ₹ 4,20,000.

Illustration 11.

The average profit earned by a firm is ₹ 80,000 which includes undervaluation of stock of ₹ 8,000 on an average basis. The capital invested in the business is ₹ 8,00,000 and the normal rate of return is 8%. Calculate goodwill of the firm on the basis of 7 times the super profit.

(*Delhi 2015 C*)

Solution:

Average Profit = ₹ 80,000

Undervaluation of Stock = ₹ 8,000

Adjusted Average Profit = ₹ 80,000 + ₹ 8,000 (Note) = ₹ 88,000

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

= ₹ 8,00,000 × = ₹ 64,000

Super Profit = Adjusted Average Profit – Normal Profit

= ₹ 88,000 – ₹ 64,000 = ₹ 24,000

Goodwill = Super Profit × 7

= ₹ 24,000 × 7 = ₹ 1,68,000.

Note: Undervaluation of stock reduces the net profit. Hence, it is added to determine adjusted profit.

Unsolved Questions

1. *X* and *Y* are partners sharing profits and losses in the ratio of 3 : 2. They admit *Z* for 1/5th share. For this purpose, the Goodwill of the firm is to be valued on the basis of three years' purchase of last five years' average profits.

   The profits were:

Year	2021–22	2022–23	2023–24	2024–25	2025–26
Profits (₹)	50,000	60,000	40,000	65,000	80,000

   The profit of 2024–25 was calculated after charging ₹ 5,000 for loss of goods by fire. Calculate the Goodwill of the firm. [**Ans.:** *Value of Goodwill* = ₹ *1,80,000.*]

2. Calculate the value of Goodwill as on 1st April, 2026 on the basis of three years' purchase of the average profits of the last five years. The profits and losses for the years were: 2021–22—(Loss) ₹ 80,000 (including Profit on sale of furniture during the year ₹ 4,000), 2022–23—₹ 1,84,000, 2023–24—₹ 1,00,000 (profit on sale of machinery during the year ₹ 10,000); 2024–25—₹ 1,50,000; 2025–26—₹ 1,80,000 (including loss on sale of computer ₹ 10,000). **[Ans.:** *Goodwill* = ₹ *3,18,000; Average Profit* = ₹ *1,06,000.*]

3. A firm earns profit of ₹ 1,00,000. The Normal Rate of Return in a similar type of business is 10%. The value of total assets (excluding Goodwill) and total outsiders' liabilities as on the date of valuation of Goodwill are ₹ 12,00,000 and ₹ 3,80,000 respectively. Calculate the value of Goodwill according to Capitalisation of Super Profit Method. **[Ans.:** *Goodwill = ₹ 18,000 (Super Profit) × 100/10 = ₹ 1,80,000.*]

4. Ravi and Kant are partners in a business with balances in their Capital and Current Accounts as on 31st March, 2026 were:

	Capital Account	Current Account
Ravi	₹ 2,50,000	₹ 50,000
Kant	₹ 3,00,000	₹ 25,000 (Dr.)

The firm earned an average profit of ₹ 1,25,000. If the normal rate of return is 10%, find the value of goodwill by Capitalisation Method. [**Ans.:** *Value of Goodwill = ₹ 6,75,000.*]

5. Calculate the goodwill of a firm on the basis of three years' purchase of the weighted average profit of the last four years. Profits of these four years ended 31st March, were:

Year Ended	31st March, 2023	31st March, 2024	31st March, 2025	31st March, 2026
Profits (₹)	40,400	49,600	40,000	60,000

The weights assigned to each year ended 31st March are: 2023—1; 2024—2; 2025—3 and 2026—4.

You are provided with the following additional information:

(i) On 31st March, 2025, a major plant repair was undertaken for ₹ 12,000 which was charged to revenue. The said sum is to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on Written Down Value Method.

(ii) The Closing Stock for the year ended 31st March, 2024 was overvalued by ₹ 4,800.

(iii) To cover management cost an annual charge of ₹ 9,600 should be made for the purpose of goodwill valuation. **[Ans.:** *Value of Goodwill = ₹ 1,31,880.*]

6. Mahesh and Suresh are partners and they admit Naresh into partnership. They agreed to value goodwill at three years' purchase on Weighted Average Profit Method taking profits for the last five years. They assigned weights from 1 to 5 beginning from the earliest year and onwards. The profits for the last five years were as follows:

Year ended	31st March, 2022	31st March, 2023	31st March, 2024	31st March, 2025	31st March, 2026
Profits (₹)	1,25,000	1,40,000	1,20,000	55,000	2,57,000

Books of Account revealed the following:

(i) A second hand machine was purchased for ₹ 5,00,000 on 1st July, 2024 and ₹ 1,00,000 were spent to make it operational. ₹ 1,00,000 were wrongly debited to Repairs Account. Machinery is depreciated @ 20% p.a. on Written Down Value Method.

(ii) Closing Stock as on 31st March, 2025 was undervalued by ₹ 50,000.

(iii) Remuneration to partners was to be considered as charge against profit and remuneration of ₹ 30,000 p.a. for each partner was considered appropriate.

Calculate the value of goodwill. [**Ans.:** *Value of Goodwill—₹ 3,15,000.*]

7. Rakesh and Ashok earned a profit of ₹ 5,000. They employed capital of ₹ 25,000 in the firm. It is expected that the normal rate of return is 15% of the capital. Calculate amount of goodwill if goodwill is valued at three years' purchase of super profit. [**Ans.:** *Goodwill—₹ 3,750.*]

8. A firm earns ₹ 3,00,000 as its annual profit, the rate of return being 12%. Assets and liabilities of the firm amounted to ₹ 36,00,000 and ₹ 12,00,000 respectively. Calculate value of goodwill by Capitalisation Method. [**Ans.:** *Goodwill—₹ 1,00,000.*]

9. Anish and Manish are partners and they admit Ravish into partnership. They agreed to value goodwill at three years' purchase on Weighted Average Profit Method taking profits for the last five years. They assigned weights from 1 to 5 beginning from the earliest year and onwards. The profits for the last five years were as follows:

Year ended	31st March, 2022	31st March, 2023	31st March, 2024	31st March, 2025	31st March, 2026
Profits (₹)	1,25,000	1,40,000	1,20,000	55,000	2,57,000

Books of Account revealed the following:

(i) A second hand machine was purchased for ₹ 5,00,000 on 1st April, 2024 and ₹ 1,00,000 were spent to make it operational. ₹ 1,00,000 were wrongly debited to Repairs Account. Machinery is depreciated @ 20% p.a. on Written Down Value Method.

(ii) Closing Stock as on 31st March, 2025 was undervalued by ₹ 50,000.

(iii) Remuneration to partners was to be considered as charge against profit and remuneration of ₹ 20,000 p.a. for each partner was considered appropriate.

Calculate the value of goodwill. [**Ans.:** *Value of Goodwill—₹ 3,12,000.*]