

# Chapter 2 · Goodwill — Nature and Valuation

CBSE Class 12 Accountancy (055) · Part A · Unit 1 = 36 marks · Ultimate Revision Sheet

## 60-SECOND RECALL

|                      |                                                                                                                             |
|----------------------|-----------------------------------------------------------------------------------------------------------------------------|
| <b>Definition</b>    | The <b>value of the reputation</b> of a firm which enables it to earn <b>higher profits</b> than the normal rate of return. |
| <b>Nature</b>        | <b>Intangible</b> asset — but <b>NOT fictitious</b> . It has a realisable value.                                            |
| <b>3 methods</b>     | <b>Average Profit · Super Profit · Capitalisation</b>                                                                       |
| <b>Super Profit</b>  | Average Profit – Normal Profit                                                                                              |
| <b>Normal Profit</b> | Capital Employed × Normal Rate of Return ÷ 100                                                                              |
| <b>AS 26 rule</b>    | <b>Only purchased goodwill</b> is recorded. <b>Self-generated goodwill is NEVER recorded.</b>                               |

### 1. Meaning & Nature

**WRITE THIS VERBATIM** Goodwill is the value of the reputation of a firm built over time, which enables it to earn **higher profits than the normal rate of return** earned by other firms in the same business.

**Nature:** goodwill is an **intangible asset**, not a fictitious asset. A fictitious asset (like deferred revenue expenditure) has **no realisable value**; goodwill **can be sold** along with the business.

**GUARANTEED 1-MARKER** “Is goodwill a fictitious asset?” → **No. It is an intangible asset**, because it has a realisable value.

### 2. Factors Affecting Goodwill

**L-E-N-M-Q-R** — **L**ocation, **E**fficiency of management, **N**ature of business, **M**arket situation, **Q**uality, **R**isk

1. **Nature of business** — stable demand, favourable government policy and low risk raise goodwill.
2. **Location** — a firm in a prime, customer-facing location earns more.
3. **Efficiency of management** — better management → higher profits → higher goodwill.
4. **Market situation** — monopoly or limited competition raises goodwill.
5. **Special advantages** — import licences, long-term supply contracts, patents, trademarks, low-cost power.
6. **Quality of product** — consistent quality builds repeat custom.

### 3. Need for Valuation

Goodwill is valued when the **mutual rights of partners change**: (a) change in profit sharing ratio (b) admission of a partner (c) retirement or death of a partner (d) dissolution where the business is sold as a going concern (e) amalgamation of firms.

All three methods ask the same thing: *how much MORE than normal does this firm earn?*

#### 1. AVERAGE PROFIT

Simplest. Ignores how much capital was needed to earn it

$\text{Avg Profit} \times \text{No. of Years' Purchase}$

#### 2. SUPER PROFIT

Now capital matters. Only the EXCESS over normal is paid for.

$\text{Super Profit} \times \text{No. of Years' Purchase}$

#### 3. CAPITALISATION

No "years' purchase" at all — the rate of return does that job

$\text{Super Profit} \times 100 \div \text{Normal Rate of Return}$

Methods 2 and 3 both need these three, in this order:

Capital Employed  
Assets - Outside Liab.



Normal Profit  
 $\text{Cap. Employed} \times \text{NRR}$



Super Profit  
Actual - Normal Profit

In Capital Employed, exclude goodwill, non-trade investments and fictitious assets.

Method 1 pays for total profit; methods 2 and 3 pay only for the profit above normal.

## 4. Method 1 — Average Profit

### SIMPLE AVERAGE

**Average Profit = Total Adjusted Profits ÷ Number of Years**

**Goodwill = Average Profit × Number of Years' Purchase**

### WEIGHTED AVERAGE — use when profits show a clear trend

**Weighted Average Profit =  $\Sigma(\text{Profit} \times \text{Weight}) \div \Sigma \text{Weights}$**

Weights run 1, 2, 3, 4... with the highest weight on the most recent year.

**WHEN TO USE WHICH** Use weighted average when the question says profits are showing a *rising or falling trend*, or gives weights. Otherwise use *simple average*. Choosing wrong loses the whole calculation.

Adjusting the profits — where most marks are lost

**WORKING NOTE — ALWAYS DO THIS FIRST** Before averaging, correct each year's profit:

| Item                                                                        | Treatment                                       |
|-----------------------------------------------------------------------------|-------------------------------------------------|
| Abnormal <b>loss</b> (theft, fire) debited to P&L                           | <b>ADD</b> back                                 |
| Abnormal <b>gain</b> (lottery, speculation profit)                          | <b>SUBTRACT</b>                                 |
| Income from <b>non-trade investments</b>                                    | <b>SUBTRACT</b>                                 |
| Expense on an asset <b>wrongly charged to revenue</b> (capital expenditure) | <b>ADD</b> back, then deduct depreciation on it |
| <b>Overvaluation</b> of closing stock                                       | <b>SUBTRACT</b> from that year's profit         |
| <b>Undervaluation</b> of closing stock                                      | <b>ADD</b> to that year's profit                |
| Expense expected in <b>future</b> (e.g. partner's remuneration)             | <b>SUBTRACT</b>                                 |

**Stock trap:** overvalued *closing* stock of one year becomes overvalued *opening* stock of the next — so the *next* year's profit must be *increased* by the same amount.

## 5. Method 2 — Super Profit

### THE THREE-STEP CHAIN

1. Capital Employed = Total Assets (excl. goodwill, non-trade investments, fictitious assets) – Outside Liabilities

2. Normal Profit = Capital Employed × Normal Rate of Return ÷ 100

3. Super Profit = Average (actual) Profit – Normal Profit

4. Goodwill = Super Profit × Number of Years' Purchase

**TRAP** If Super Profit is negative or zero, goodwill is NIL. Do not report a negative goodwill figure.

Capital employed can also be found as  $\text{Capital Employed} = \text{Partners' Capital} + \text{Reserves} - \text{Fictitious Assets}$ . Both routes must give the same number — if they do not, recheck.

## 6. Method 3 — Capitalisation

### (a) CAPITALISATION OF AVERAGE PROFIT

Capitalised Value of Firm = Average Profit × 100 ÷ Normal Rate of Return

Goodwill = Capitalised Value – Capital Employed (Net Assets)

### (b) CAPITALISATION OF SUPER PROFIT

Goodwill = Super Profit × 100 ÷ Normal Rate of Return

**WORKED EXAMPLE — all three methods, same data** Average profit ₹80,000 · Capital employed ₹5,00,000 · Normal rate 10% · 3 years' purchase.

Average profit method:  $80,000 \times 3 = ₹2,40,000$

Super profit method: Normal =  $5,00,000 \times 10\% = 50,000$ . Super =  $80,000 - 50,000 = 30,000$ . Goodwill =  $30,000 \times 3 = ₹90,000$

Capitalisation of super profit:  $30,000 \times 100/10 = ₹3,00,000$

Capitalisation of average profit:  $(80,000 \times 100/10) - 5,00,000 = 8,00,000 - 5,00,000 = ₹3,00,000$

Note the two capitalisation routes agree. If yours do not, the capital employed is wrong.

## 7. AS 26 — The Accounting Rule

**MEMORISE THIS** Under AS 26 (Intangible Assets), goodwill is recorded in the books only when it is purchased, i.e. when consideration is paid for it. Self-generated goodwill is never recorded.

**Consequence for partnership questions:** on admission, retirement or a change in ratio, goodwill is **NOT** raised in the books. It is adjusted through the partners' capital / current accounts only.

#### THE ONLY ENTRY YOU NEED

| Adjustment of goodwill                                                    | Dr  | Cr  |
|---------------------------------------------------------------------------|-----|-----|
| Gaining Partner's Capital A/c Dr.<br>To Sacrificing Partner's Capital A/c | ... | ... |

**Gainer pays, sacrificer receives.** That one sentence covers admission, retirement and change in ratio.

**TRAP** If goodwill **already appears** in the balance sheet at the time of reconstitution, it must first be **written off** among **all old partners in the OLD ratio**:

All Partners' Capital A/c Dr. (old ratio) To Goodwill A/c

## 8. Question Triggers which method does the wording want?

| If the question says...                            | Use                                                            |
|----------------------------------------------------|----------------------------------------------------------------|
| "X years' purchase of average profit"              | Average profit method                                          |
| "profits show an increasing trend" / weights given | <b>Weighted</b> average                                        |
| "normal rate of return" + "capital employed"       | Super profit method                                            |
| "capitalised value of the firm"                    | Capitalisation of average profit                               |
| "goodwill at X% of super profit capitalised"       | Capitalisation of super profit                                 |
| "stock was overvalued by ₹X in 2023"               | Subtract from 2023, <b>add to 2024</b>                         |
| "a machine purchase was debited to repairs"        | Add back, then deduct depreciation                             |
| "loss by fire not covered by insurance"            | Abnormal loss → <b>add back</b>                                |
| "profit on sale of a fixed asset"                  | Abnormal gain → <b>subtract</b>                                |
| "partner to be paid a salary in future"            | <b>Subtract</b> from each year's profit                        |
| "non-trade investments"                            | Exclude from capital employed <b>and</b> subtract their income |
| Goodwill already in the balance sheet              | Write off in <b>OLD ratio</b> first                            |

### MOST-ASKED BOARD QUESTIONS

- [3-4M]** Calculate goodwill by the average / weighted average profit method with adjustments.
- [3-4M]** Calculate goodwill by the super profit method.
- [4M]** Calculate goodwill by capitalisation of super profit / average profit.
- [1-3M]** State any three factors affecting the value of goodwill.
- [1M]** Why is self-generated goodwill not recorded? → **AS 26 permits only purchased goodwill**
- [1M]** Give the formula for super profit. → **Average profit - Normal profit**

**THE HABIT THAT SCORES** — Write the adjusted-profit table as **WN1** before you touch any formula. Most goodwill questions are lost in the adjustment step, not the formula step — and a visible adjustment table earns method marks even if one item is misclassified.