

## Goodwill in Accounting

Goodwill is a special type of asset in accounting that isn't something you can see or touch, like cash or buildings. Instead, it represents the extra value of a business beyond its physical assets. This extra value comes from things like the company's good reputation, loyal customers, strong brand, and positive relationships with suppliers.

## Valuation of Goodwill

Valuing goodwill means figuring out how much this intangible asset (the extra value of a business beyond its physical assets) is worth. The value of goodwill is important because it can significantly affect the overall value of a business, especially when one company buys another.

## Methods of Valuation of Goodwill

There are several ways to calculate the value of goodwill. Here are the most common methods.

1. **Average Profit Method:** The Average Profit Method is one of the simplest and most common ways to calculate the value of goodwill for a business. It is based on the logical assumption that a new owner will benefit from the same level of profits that the business has earned in the recent past.

**Formula:** To calculate goodwill using this method, we use two steps:

**Calculate Average Profit** =  $\frac{\text{Total Profits of Given Years}}{\text{Number of Years}}$

**Calculate Goodwill** = Average Profit \* Number of Years' Purchase

**Example:** A firm wants to calculate its goodwill based on 3 years' purchase of the average profits of the last 4 years.

The reported profits were:

- Year 1: RS.50,000
- Year 2: RS.70,000
- Year 3: RS.40,000
- Year 4: RS.60,000

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The solution:

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

$$= \frac{50000 + 70000 + 40000 + 60000}{4}$$

$$= 55000$$

Calculate Goodwill = Average Profit \* Number of Years' Purchase

$$= 55000 * 3 = 165000$$

**2. Super Profit Method:** While the Average Profit Method looks at everything a business earns, the Super Profit Method focuses only on the "extra" money a business makes compared to its competitors.

**Formula:** To calculate Goodwill using this method, follow these four steps:

**Step 1: Calculate Capital Employed:** This is the total investment in the business (Assets minus Liabilities).

**Capital Employed** = Total Assets - Outside Liabilities

**Step 2: Calculate Normal Profit:** This is what an average business in the same industry would earn on that investment.

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

**Step 3: Calculate Super Profit:** Subtract the "Normal" profit from the "Actual/Average" profit the business is currently making.

**Super Profit** = Actual Average Profit - Normal Profit

**Step 4: Calculate Goodwill:** Multiply the Super Profit by the number of years' purchase.

**Goodwill** = Super Profit \* Number of Years' Purchase

**Example:** Let's say a firm has the following data

- Average Profit: RS.80,000
- Capital Employed: Rs.500,000
- Normal Rate of Return (NRR): 12%

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•Years' Purchase: 3

The Solution:

Normal Profit = Capital Employed \* Normal Rate of Return

100

$$= 5,00,000 * 12/100$$

$$= 60000$$

Super Profit = Actual Average Profit - Normal Profit

$$= 80,000 - 60,000 = 20,000$$

Goodwill = Super Profit \* Number of Years' Purchase

$$= 20,000 * 3 = 60,000$$

**3. Capitalization Method:** In the world of accounting and business valuation, Capitalized Goodwill methods help you put a price tag on the "intangible magic" of a company—things like brand reputation, loyal customers, and proprietary tech—that allow it to earn more than its peers.

Essentially, these methods assume that if a business earns "extra" money, that money must be coming from an invisible asset called Goodwill.

(i) **Capitalization of Average Profits:** This method looks at the business as a whole. It asks: "Given the current market interest rate, how much capital would a normal company need to earn the profits this company is making

**Formula: Calculate Capitalized Value of the Firm**

Step 1: Average Normal Profit \* 100

$$= \frac{\text{Average Normal Profit} * 100}{\text{Normal Rate of Return}}$$

Step 2: Net Assets (Capital Employed) = Total Assets - Outside Liabilities

Step 3: Goodwill = Capitalized Value - Net Assets (Capital Employed)

**Example:** calculate the value of the company's Goodwill using the Capitalization of Average Profits Method based on the following financial data:

- Average Annual Profits: Rs.150,000
- Total Assets: Rs.1,400,000
- Outside Liabilities: Rs.400,000
- Normal Rate of Return (NRR): 12%

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**The Solution:**

**Step 1: Calculate the Capitalized Value of the Business:** This represents how much capital a "normal" company would need to earn Rs.150,000 at a 12% return.

$$\begin{aligned} \text{Capitalized Value} &= \frac{\text{Average Normal Profit} * 100}{\text{Normal Rate of Return}} \\ &= 150,000 / 12 * 100 \\ &= 1,250,000 \end{aligned}$$

**Step 2: Calculate the Net Assets (Capital Employed)**

$$\begin{aligned} &= \text{Total Assets} - \text{Outside Liabilities} \\ &= 14,00,000 - 4,00,000 \\ &= 10,00,000 \end{aligned}$$

**Step 3: Calculate the Goodwill**

$$\begin{aligned} &= \text{Capitalized Value} - \text{Net Assets} \\ &= 1,250,000 - 1,000,000 \\ &= 250,000 \end{aligned}$$

**(ii) Capitalization of Super Profit Method :** This method focuses only on the excess profit (Super Profit) that a business earns over and above the normal industry expectations. Instead of capitalizing the whole profit, we only capitalize the "extra" bit.

**Formula**

**Step 1: Calculate Capital Employed:** This is the total investment in the business (Assets minus Liabilities).

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

**Step 2: Normal Profit:** Find what a standard business would earn with your capital.

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

**Step 3: Calculate Super Profit:** Subtract the normal profit from your actual average profit.

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

**Step 4: Compute Goodwill:** Capitalize the super profit directly.

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

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**Example:** Imagine a company, Elite Electronics, with the following financial snapshot:

- Total Assets: Rs12,00,000
- Outside Liabilities: Rs.2,00,000
- Average Annual Profit: Rs. 150,000
- Normal Rate of Return (NRR): 10%

**The Solution:**

**Step 1. Find the Capital Employed**

$$\begin{aligned}
 &= \text{Total Assets} - \text{Outside Liabilities} \\
 &= 12,00,000 - 2,00,000 \\
 &= 10,00,000
 \end{aligned}$$

**Step 2. Calculate the Normal Profit**

$$\begin{aligned}
 &\text{Capital Employed} * \text{Normal Rate of Return} \\
 &= \frac{10,00,000 * 10}{100} \\
 &= 1,00,000
 \end{aligned}$$

**Step 3. Calculate the Super Profit**

$$\begin{aligned}
 &= \text{Average Profit} - \text{Normal Profit} \\
 &= 150,000 - 100,000 \\
 &= 50,000
 \end{aligned}$$

**Step 4. Calculate Goodwill**

$$\begin{aligned}
 &\frac{\text{Super Profit} * 100}{\text{Normal Rate of Return}} \\
 &= \frac{50,000 * 100}{10} \\
 &= 5,00,000
 \end{aligned}$$

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Ques 1. The profits of "Lunar Tech" for the last five years ending on March 31 were:

- 2021: Rs.40,000
- 2022: Rs.55,000
- 2023: Rs.48,000
- 2024: Rs.60,000
- 2025: Rs.57,000



ICSE

Calculate the value of Goodwill on the basis of 3 years' purchase of the average profit of the last five years. [Hint:1,56,000]



NTSE

Ques 2. A firm has a Capital Investment of Rs.500,000. The Normal Rate of Return (NRR) for this industry is 10%. The firm's Actual Average Profit is Rs.85,000. Calculate Goodwill based on 4 years' purchase of Super Profit. [Hint: 1,40,000]



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Ques 3. The average profit of "Bright Spark Co." is Rs. 50,000. The total assets of the firm are Rs.500,000 and external liabilities are Rs.100,000. In similar businesses, the normal rate of return on capital employed is 10%. Calculate the value of goodwill using the Capitalization of Average Profits Method. [Hint:1,00,000]



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Ques 4. A firm has a Capital Employed of Rs.5,00,000. The Average Profit for the last few years is Rs.80,000. The Normal Rate of Return in this line of business is 10%. Calculate the value of Goodwill using the Capitalization of Super Profit Method. [Hint:3,00,000]



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