- **Nature and Characteristics of Goodwill:**

  It is a valuable intangible asset (an asset which cannot be seen and touched) like patents, trademarks, copyrights, etc. It is not depreciated like tangible assets but is amortised over its useful life. *Accounting Standard–26 (AS–26), Intangible Assets* prescribes that goodwill should not be recorded in the books of account unless consideration is paid for it. Therefore, self-generated goodwill is not recorded in the books of account but purchased goodwill is recorded. It can be sold, though a sale will be possible only along with the sale of the business itself.

  The characteristics of goodwill are:

  (*i*) It is an intangible asset, *i.e.*, an asset which cannot be seen or touched.

  (*ii*) It does not have an existence separate from that of an enterprise. Thus, it has realisable value when business is sold.

  (*iii*) It helps in earning higher profits.

  (*iv*) It is an attractive force which brings in customers to old place of business.

  (*v*) It comes into existence due to various factors such as locational advantages, favourable contracts, brands, trademarks, patents, market reputation, etc.

  (*vi*) In the context of partnership, it is the value of share of profit sacrificed by the sacrificing partner.

  (*vii*) Value of goodwill is subjective as it depends on the assessment of the valuer.

- **Factors Affecting the Value of Goodwill:** Value of goodwill depends upon the capacity of the business to earn excess profits. Therefore, all such factors which help to increase the profitability of business, will also affect the value of goodwill. These factors are: 1. Efficient 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, good labour relations, etc.

  In determining normal business profits, interest earned on non-trade investments, is excluded.

- **Need for Valuation of Goodwill for Partnership Firms:** 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.

- **Methods of Valuation of Goodwill:** 1. Average Profit Method: Simple Average Profit Method; and Weighted Average Profit Method, 2. Super Profit Method, and 3. Capitalisation Method: Capitalisation of Average Profit Method; and Capitalisation of Super Profit Method.

Characteristics or Features of Goodwill

The characteristics of goodwill are:

1. It is an intangible asset, *i.e.*, an asset which cannot be seen or touched.
2. It does not have an existence separate from that of an enterprise. Thus, it has realisable value when business is sold.
3. It helps in earning higher profits.
4. It is an attractive force which brings in customers to old place of business.
5. It comes into existence due to various factors such as locational advantages, favourable contracts, brands, trademarks, patents, market reputation, etc.
6. In the context of partnership, it is the value of share of profit sacrificed by the sacrificing partner.
7. Value of goodwill is subjective as it depends on the assessment of the valuer.

...assessment of the valuer.

Methods of Valuation of Goodwill

Value of goodwill is personal assessment of the valuer and is usually agreed among the partners. It is valued as per the method stated in the Partnership Deed or as per the method of valuation agreed by the partners. However, following three methods are followed for valuing goodwill:

1. Average Profit Method:

   (*i*) Simple Average Profit Method; and (*ii*) Weighted Average Profit Method

2. Super Profit Method, and

3. Capitalisation Method:

   (*i*) Capitalisation of Average Profit Method; and (*ii*) Capitalisation of Super Profit.

1. Average Profit Method

Goodwill under Average Profit Method can be calculated either by:

(*i*) Simple Average Profit Method; or

(*ii*) Weighted Average Profit Method.

... profit because of the efforts put in the past.

Valuation of Goodwill

Step 1: Calculate Normal Profit

Goodwill under this method is calculated on average normal profit of each of the past years considered for calculating goodwill.

Normal Business Profit (or Future Maintainable Profit) is calculated for each year as follows:

Profit or Loss (Given) of Past Year (Before Adjustment):		...
Add:	(*i*) Abnormal Losses (*e.g.*, Loss by fire, theft, etc.)	...
	(*ii*) Loss on Sale of Fixed Assets (Since it is not a normal business activity)	...
	(*iii*) Overvaluation of Opening Stock or Undervaluation of Closing Stock (Since it would have reduced the profits)	...
	(*iv*) Non-recurring Expenses (Such expenses are not expected in future)	...
	(*v*) Capital Expenditure charged as Revenue Expenditure (*e.g.*, Purchase of machinery wrongly debited to Purchases Account)	...
		...
Less:	(*i*) Abnormal Gains (*e.g.*, Profit on Sale of Fixed Assets)	(...)
	(*ii*) Overvaluation of Closing Stock or undervaluation of Opening Stock (As it would have increased the profit)	(...)
	(*iii*) Non-recurring Incomes (Such incomes are not expected in future)	(...)
	(*iv*) Partners' Remuneration, if it is not deducted (As it is the value of their services to be paid in future years)	(...)
	Adjusted Profit (Future Maintainable Profit)	...

Step 2: Find Average Profit

Add the normal profit (as calculated in **Step 1**) for all the years and divide the sum of it by the number of years for which profit is determined to calculate the average profit.

Step 3: Determine the Number of Years' Purchase

Number of years' purchase means the years for which the firm is likely to earn that much profit because of the efforts made in the past. It is the estimate made for valuation of goodwill.

Step 4: Find Value of Goodwill

Value of Goodwill is calculated by applying the following formula:

Goodwill = Average Profit (as per **Step 2**) × Number of Years' Purchase (as per **Step 3**)

Illustration 3 (*Average Profit Method when Adjustments are Made*). Simran purchased Anita's business on 1st April, 2017. It was agreed to value goodwill at three years' purchase of average normal profit of the last four years. The profits of Anita's business for the last four years were:

Year ended	₹
31st March, 2014	90,000;
31st March, 2015	1,60,000;
31st March, 2016	1,80,000;
31st March, 2017	2,20,000.

5. *A*, *B* and *C* are partners sharing profits and losses equally. They agree to admit *D* for equal share. For this purpose, the value of goodwill is to be calculated on the basis of four years' purchase of average profit of last five years. These profits were:

Year	2009–10	2010–11	2011–12	2012–13	2013–14
Profit/(Loss) (₹)	1,50,000	3,50,000	5,00,000	7,00,000	(6,00,000)

On 1st April, 2013, a car costing ₹ 1,00,000 was purchased and debited to Travelling Expenses Account, on which depreciation is to be charged @ 25%.

Calculate the value of goodwill after adjusting the above.

6. *A* and *B* are partners sharing profits in the ratio of 3 : 2. They decided to admit *C* as a partner from 1st April, 2017 on the following terms:

(i) *C* will be given 2/5th share of the profit.

(ii) Goodwill of the firm will be valued at two years' purchase of three years' normal average profit of the firm.

Profits of the previous three years ended 31st March, were:

2017—Profit ₹ 30,000 (after debiting loss of stock by fire ₹ 40,000).

2016—Loss ₹ 80,000 (includes voluntary retirement compensation paid ₹ 1,10,000).

2015—Profit ₹ 1,10,000 (including a gain (profit) of ₹ 30,000 on the sale of fixed assets).

You are required to value the goodwill.

7. *X* and *Y* are partners sharing profits and losses in the ratio of 3 : 2. They admit *Z* into partnership for 1/4th share in goodwill. *Z* brings in his share of goodwill in cash. Goodwill for this purpose is to be calculated at two years' purchase of the average normal profit of past three years. Profits of the last three years ended 31st March, were:

2015—Profit ₹ 50,000 (including profit on sale of assets ₹ 5,000).

2016—Loss ₹ 20,000 (including loss by fire ₹ 30,000).

2017—Profit ₹ 70,000 (including insurance claim received ₹ 18,000 and interest on investments and Dividend received ₹ 8,000).

Calculate value of goodwill. Also, calculate goodwill brought in by *Z*.

8. Sumit purchased Amit's business on 1st April, 2017. Goodwill was decided to be valued at two years' purchase of average normal profit of last four years. The profits for the past four years were:

Year Ended	31st March, 2014	31st March, 2015	31st March, 2016	31st March, 2017
Profits (₹)	80,000	1,45,000	1,60,000	2,00,000

Verification of books of account revealed the following:

(i) Abnormal loss of ₹ 20,000 was debited to Profit and Loss Account for the year ended 31st March, 2014.

(ii) A fixed asset was sold in the year ended 31st March, 2015 and gain (profit) of ₹ 25,000 was credited to Profit and Loss Account.

(iii) In the year ended 31st March, 2016 assets of the firm were not insured due to oversight. Insurance premium not paid was ₹ 15,000.

Calculate the value of goodwill.