**Methods of Goodwill Valuation**

Goodwill is the value of the reputation of a firm built over time with respect to the expected future profits over and above the normal profits. Goodwill is an intangible real asset which cannot be seen or felt but exists in reality and can be bought and sold. In partnership, goodwill valuation is very important. Thus, we will here discuss the various methods of Goodwill Valuation.

**Goodwill Valuation**

A well-established firm earns a good name in the market, builds trust with the customers and also has more business connections as compared to a newly set up business. Thus, the monetary value of this advantage that a buyer is ready to pay is termed as Goodwill. The buyer who pays for Goodwill expects that he will be able to earn super profits as compared to the profits earned by the other firms. Thus, goodwill exists only in the case of firms making super profits and not in the case of firms earning normal profits or losses.

Goodwill is recorded in the books only when some consideration in money or money’s worth is paid for it. Thus, in the context of a partnership firm, the need for valuation of goodwill arises at the time of:

1. Change in the profit sharing ratio amongst the existing partners
2. Admission of a new partner
3. The [retirement of a partner](https://www.toppr.com/guides/accountancy/retirement-or-death-of-a-partner/)
4. Death of a partner
5. Dissolution of a firm where business is sold as going concern.
6. Amalgamation of partnership firms

**Methods of Valuation of Goodwill**

The choice of the method of goodwill valuation depends entirely on the partners or the partnership deed when they have made it.

**1. Average Profits Method**

i] Simple Average: Under this method, the goodwill is valued at the agreed number of years’ of purchase of the average profits of the past years. Goodwill = Average Profit x No. of years’ of purchase

ii] Weighted Average: Under this method, the goodwill is valued at an agreed number of years’ of purchase of the weighted average profits of the past years. We use the weighted average when there exists an increasing or decreasing trend in the profits giving the highest weight to the current year’s profit.

* Goodwill = Weighted Average Profit x No. of years’ of purchase
* Weighted Average Profit = Sum of Profits multiplied by weights/ Sum of weights

**2. Super Profits Method**

(i) The Number of Years Purchase Method: Under this method, the goodwill is valued at the agreed number of years’ of purchase of the super profits of the firm.

* Goodwill = Super Profit x No. of years’ of purchase
* # Super Profit = Actual or Average profit – Normal Profit
* # Normal Profit = Capital Employed x (Normal Rate of Return**/**100)

(ii) Annuity Method: This method considers the time value of money. Here, we consider the discounted value of the super profit.

* Goodwill = Super Profit x Discounting Factor

**3. Capitalization Method**

(i) Capitalization of Average Profits: Under this method, the value of goodwill is calculated by deducting the actual capital employed from the capitalized value of the average profits on the basis of the normal rate of return.

* Goodwill = Normal Capital – Actual Capital Employed
* # Normal Capital or Capitalized Average profits = Average Profits x (100/Normal Rate of Return)
* # Actual Capital Employed = Total Assets (excluding goodwill) – Outside Liabilities

(ii) Capitalization of Super Profits: Under this method, Goodwill is calculated by capitalizing the super profits directly.

* Goodwill = Super Profits x (100/ Normal Rate of Return)

**Solved Example on Methods of Goodwill Valuation**

Q1. M/s Mehta and sons earn an average profit of rupees 60,000 with a capital of rupees 4,00,000. The normal rate of return is 10%. Using capitalization of super profits method calculate the value the goodwill of the firm.

Ans: Goodwill = Super profits x (100/ Normal Rate of Return) = 20,000 x 100/10 = 2,00,000.

Working notes:

(i). Normal Profit = Capital employed x Normal Rate of Return/100 =  4,00,000 x 10/100 =  40,000

(ii) Super Profit = Average Profit – Normal Profit = 60,000 – 40,000 = 20,000

Q 2. M/s Joe and John is a partnership firm with Joe and John as its partners. They now decide to admit James in the firm and hence need to value goodwill. Capital employed is 5,00,000 at the end of the 4thyear. The normal rate of return is 15%. Assume the interest rate is equal to the Normal Rate of Return. Calculate Goodwill using Annuity Method. Their profits for the last 4 years are:

|  |  |
| --- | --- |
| Year | Profits |
| 1 | 100000 |
| 2 | 120000 |
| 3 | 150000 |
| 4 | 200000 |

Ans: Goodwill = Super Profit x Discounting factor =  67500 x 2.855 = 192713

Working notes:

(i) Average Profit = Sum of profits / No. of years = 570000/4 = 142500

(ii) Normal Profit = Capital employed x (Normal Rate of Return/100) = 500000 x (15/100) = 75000

(iii) Super Profit = Average Profit – Normal Profit = 142500 – 75000 = 67500