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Reconstitution of a Partnership Firm –Admission of a Partner

Supper Profits Method

The basic assumption in the average profits (simple or weighted) method of calculating goodwill is that if a new business is set up, it will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases an existing business has to pay in the form of goodwill a sum equal to the total profits he is likely to receive for the first 'few years'. But it is contended that the buyer's real benefit does not lie in total profits; it is limited to such amounts of profits which are in excess of the normal return on capital employed in similar business. Therefore, it is desirable to value, goodwill on the basis of the excess profits and not the actual profits. The excess of actual profits over the normal profits is termed as super profits.

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

Suppose an existing firm earns Rs. 18,000 on the capital of Rs. 1,50,000 and the normal rate of return is 10%. The Normal profits will work out at Rs. 15,000 (1.50,000 × 10/100). The super profits in this case will be Rs. 3,000 (Rs. 18,000 – 15,000). The goodwill under the super profit method is ascertained by multiplying the super profits by certain number of years' purchase. If, in the above example, it is expected that the benefit of super profits is likely to be available for 5 years in future, the goodwill will be valued at Rs. 15,000 (3,000 × 5). Thus, the steps involved under the method are:

1. Calculate the average profit,

2. Calculate the normal profit on the capital employed on the basis of the normal rate of return,

3. Calculate the super profits by deducting normal profit from the average profits, and

4. Calculate goodwill by multiplying the super profits by the given number of years' purchase

Illustration 12

The books of a business showed that the capital employed on December 31, 2006, Rs. 5,00,000 and the profits for the last five years were: 1997–Rs. 40,000: 1998-Rs. 50,000; 1999-Rs. 55,000; 2000-Rs.70,000 and 2001-Rs. 85,000. You are required to find out the value of goodwill based on 3 years purchase of the super profits of the business, given that the normal rate of return is 10%.

Solution

$$\text{Normal Profits} = \frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$= \text{Rs. } \frac{5{,}00{,}000 \times 10}{100} = \text{Rs. } 50{,}000$$

Average Profits:

Year	*Profit (Rs.)*
2002	40,000
2003	50,000
2004	55,000
2005	70,000
2006	85,000
Total	**3,00,000**

Average Profits = Rs. 3,00,000/5 = Rs. 60,000
Super Profit = Rs. 60,000 – Rs. 50,000 = Rs. 10,000
Goodwill = Rs. 10,000 $\times$ 3 = Rs. 30,000