

Chapter-2 Part – A

Accounting for Partnership Firms Fundamental

According to Section -4 of the Indian Partnership Act, 1932:

“Partnership is the relations between two or more persons who have agreed to share the profits of a business carried on by all or any one of them acting for all”

Features of Partnership

- 1. Two or more persons:** There must be at least two persons to form a valid partnership. The maximum number of partners cannot exceed the number of partners prescribed by companies Act, 2013 which is 50 in any business whether banking or non- banking.
- 2. Agreement :**Partnership comes into existence by an agreement (either written or oral among the partners. The written agreement among the partners is called Partnership Deed.
- 3. Existence of business and profit motive :**A partnership can be formed for the purpose of carrying on legal business with the intention of earning profits. A joint ownership of some property by itself cannot be called a partnership.
- 4. Sharing of Profits :** An agreement between the partners must be aimed at sharing the profits. If some persons join hands to run some charitable activity, it will not be called partnership. Futher, if a partner is deprived of his right to share the profits of the business, he cannot be called as partner.
- 5. Buiness carried on by all or any of them acting for all :** It means that each partner can participate in the conduct of business and each partner is bound by the acts of other partners in respect to the business of the firm.
- 6. Relationship of Principal and Agent :** Each partner is an agent ad well as a partner of the firm. An agent, because he can bind the other partners by his acts and principal, because he himself can be bound by the acts of the other partners.

Partnership Deed

Since partnership is the outcome of an agreement, it is essential that there must be some terms and conditions agreed upon by all the partners. Such terms and conditions may be either written or oral. The law does not make it compulsory to have a written agreement. However, in order to avoid all misunderstandings and disputes, it is always the best course to have a written agreement duly signed and registered under the Act.

The partnership deed is a written agreement among the partners which contains the terms of agreement. It is also called 'Articles of Partnership'. A partnership deed should contain the following points:

1. Name and address of the firm as well as partners.
2. Name and addresses of the partners.
3. Nature and place of the business.
4. Duration, if any of partnership.
5. Capital contribution by each partner.
6. Interest on capital.
7. Drawings and interest on drawings.
8. Profit sharing ratio.
9. Interest on loan.
10. Partner's Salary/commission etc.
11. Method for valuation of goodwill and assets.
12. Accounting period of the firm and duration of partnership
13. Rights and duties of partners how disputes will be settled.
14. Decisions taken if some partner becomes insolvent.
15. Opening of Bank Account – whereas it will be in the name of firm or partners.

16. Rules to be followed in case of admission & Settlement of accounts or retirement or death of partner.

17. Revaluation of assets & liabilities, if any to be done.

18. Method of recording of firm's accounts

19. Auditing

20. Date of commencement of partnership

Benefits of Partnership Deed

(1) It regulates the rights, duties and liabilities of each partner.

(2) It helps to avoid any misunderstanding amongst the partners because all the terms and conditions of partnership have been laid down before hand in the deed.

(3) Any dispute amongst the partners may be settled easily as the partnership deed may be readily referred to.

Hence, it is always best course to have a written partnership deed duly signed by all the partners and registered under the Act.

Rules applicable in the absence of partnership deed

Profit sharing Ratio	Equal, Irrespective of capital contribution.
Interest on Capital	No Interest on Capital is to be allowed to any Partner
Interest on Drawings	No interest on Drawings is to be charged to any partner
Salary or Commission to a Partner	Not allowed to any partner
Interest on loan by a Partner	Interest is allowed @ 6% per annum.

Distribution of Profits among Partners

Transactions of the partnership firm are recorded according to the principles of Double-entry book keeping system, and as in the case of a sole proprietorship concern a partnership firm will also prepare Trading account, Profit & Loss account and Balance Sheet at the end of

every year. The only difference between accounting of a sole trader and partnership firm is that the profits of the partnership firm are divided amongst the partners.

A Profit and Loss Appropriation Account is prepared to show the distribution of profits among partners as per the provision of Partnership Deed (or as per the provision of Indian Partnership Act, 1932 in the absence of Partnership Deed). It is an extension of profit and Loss Account. It is a nominal account. It records entries for interest on capital, Interest on Drawings, Salary to the partner, and division of profits among the partners.

The Journal Entries regarding Profit and Loss Appropriation Account are as follows:

1. For transfer of balance of Profit and Loss Account

Profit and Loss A/c Dr.

To Profit and Loss Appropriation A/c

2. For Interest on Capital

For allowing Interest on capital

1. Interest on Capital A/c

To Partner's Capital/Current A/cs

(Being interest on capital allowed @ % p.a.)

2. For transferring Interest on Capital to p&L appropriation A/c.

Profit and Loss Appropriation A/c Dr.

To Interest on Capital A/c.

(Being interest on capital transferred to p&L Appropriation A/c)

3. For Salary or Commission payable to a partner

i. For allowing Salary or Commission to a partner:

Partners Salary/Commission A/c Dr.

To Partner's Capital/Current A/cs

(Being salary/commission payable to a partner)

ii. For transferring Partner's Salary/Commission A/c to Profit and Loss

Appropriation A/s:

Profit and Loss Appropriation A/cDr.

To Partner's Salary/Commission A/c

4. For transfer of Reserves:

Profit and Loss Appropriation A/cDr.

To Reserve A/c

(Being reserve created)

5. For Interest on Drawings:

1. For charging interest on a partner's drawings:

Partner's Capital/Current A/cDr.

To Interest on Drawings A/c

(Being interest on drawings charged @ % p.a.)

2. For transferring interest on drawings to Profit and Loss Appropriation A/c

Interest on Drawings A/cDr.

To Profit and Loss Appropriation A/c

(Being interest on drawings transferred to P&L appropriation A/c)

6. For transfer to Profit (i.e. Credit Balance of Profit and Loss Appropriation Account)

Profit and Loss Appropriation A/cDr.

To Partners Capital/Current A/cs

(Being profits distributed among partners)

SPECIMEN OF PROFIT AND LOSS APPROPRIATION ACCOUNT

Profit and Loss Appropriation Account

For the year ending on _____

Particulars	Rs.	Particulars	Rs.
To Interest on Capital:			
A			
B		By Profit and Loss A/c (Net Profits transferred from P & L A/c)	
To Partner's Salary/Commission		By Interest on drawings:	
To Reserves		A	
To Profits transferred to capital A/cs of:		B	
A			
B			

Partner's Capital Accounts

Partner's Capital Accounts : It is an account which represents the partners interest in the business.

In case of partnership business, a separate capital account is maintained for each partner. The capital accounts of partners may be maintained by any of the following two methods.

1. Fixed Capital Accounts
2. Fluctuating Capital Accounts

1. Fixed Capital Accounts

Under this method the original capitals invested by the partners remain constant, unless additional capital is introduced by an agreement. All entries relating to drawings, interest on capitals, interest on drawings, salary to partner, share of profits/losses are made in separate account which is called as Current Account. Thus the following two accounts are maintained

when capitals are fixed.

(i) Capital Account

This account will always show a credit balance: Balance of Capital account remains fixed, it does not change every year that is why it is called fixed capital method and only the following two transactions are recorded in the Fixed Capital Accounts:

Permanent·Additional Capital Introduced

·Permanent Capital Withdrawn or Drawings out of Capital only

Partner's Capital A/Cs

Particulars	X(Rs.)	Y(Rs.)	Particulars	X(Rs.)	Y(Rs.)
To Cash/Bank A/c (Capital Withdrawn)			By Balance b/d (Opening Cr. Balance)		
To Balance c/d (Closing balance)			By Cash/Bank A/c (Additional Capital Introduced)		

(ii) Current Account

The Current account may show a debit or credit balance. All the usual adjustments such as interest on Capital, partner's salary/commission, drawings (out of profits), interest on drawings and share in profits or losses etc. are recorded in this account. All the Current Year's adjustments are recorded in this account, that is why it is called Current account.

Partner's Current A/Cs

Particulars	X(Rs.)	Y(Rs.)	Particulars	X(Rs.)	Y(Rs.)
To Balance b/d (Opening Dr. Balance)			By Balance b/d (Opening Cr. Balance)		
To Drawings (out of Profits)			By Interest on Capital		
			By Partner's Salary or Commission		
			By Profit and Loss		

To Interest on Drawings			Appropriation A/c		
To Profit and Loss A/c			(Share in Profits)		
(Share in losses)			By Balance c/d		
To Balance c/d			(Closing Dr. Balance)		
(Closing credit Balance)					

Note :

1. Debit balance of Current Account is shown in Assets side of Balance Sheet.
2. Credits balance of Current Account A/c is shown in Liabilities side of balance Sheet.
3. Balance of Fixed Capital Accounts are always shown in Liabilities side of Balance Sheet as it will be always be credit balance.

2. Fluctuating Capital Accounts

In this method only one account i.e., Capital Account of each and every partner is prepared and all the adjustment such as interest on capital interest on drawings etc, are recorded in this account under this method, Capital account may show a debit or credit balance and the balance of this account changes frequently from time to time therefore it is called fluctuating Capital Account. In this method the capitals are not fixed. **In the absence of information, the Capital Accounts should be prepared by this method.**

Partner's Capital

Particulars	X(Rs.)	Y(Rs.)	Particulars	X(Rs.)	Y(Rs.)
To Balance b/d (Opening Dr. Balance)			By Balance b/d (Opening Cr. Balance)		
To Cash/Bank A/c (Capital Withdrawn)			By Cash/Bank A/c (Additional Capital Introduced)		
To Drawings (out of profits)			By Interest on Capital		
To Interest on Drawings			By Partner's Salary or Commission		
To Profit and Loss A/c			By Profit and Loss		
			Appropriation A/c		

(Share in losses)			(Share in Profits)		
To Balance c/d			By Balance c/d		
(Closing credit Balance)			(Closing Dr. Balance)		

INTEREST ON CAPITAL

Interest on partners capital will be allowed only when it has been specifically mentioned in the partnership deed. If interest on capital is to be allowed as per the agreement, it should be calculated with respect to the time, rate of interest and the amount of capital. Interest on Capital can be treated as either:

- An Appropriation of profit; or
- A charge against profit.

A. Interest on Capital: An Appropriation of Profits:

In case of Losses	Interest on Capital is NOT ALLOWED
In cases of Sufficient Profits	Interest on Capital is ALLOWED IN FULL
In case of Insufficient Profits	Interest will be restricted to the amount of profit. Hence, profit will be distributed in the ratio of interest on capital of each partner.

B. Interest on Capital: As a Charge against Profits:

Interest on Capital is always allowed in full irrespective of amount of profits of losses.

Note:

Interest on Capital is always calculated on the OPENING CAPITAL.

If Opening Capital is not given in the question, it should be ascertained as follows:

--	--

Particulars	(Rs.)
Capital at the End	_____
Add: 1. Drawingxxxxxxx	
2. Interest on Drawingsxxxxxxx	
3. Losses during the year xxxxxx	
Less: 1. Additional Capital Introduced (xxxxxxx)	
2. Profits during the year (xxxxxxx)
3. Any salary/commission received	
Opening Capital	

INTEREST ON DRAWINGS

Interest on drawing is charged by the firm only when it is clearly mentioned in Partnership Deed. It is calculated with reference to the time period for which the money was withdrawn. There are two cases in which calculation of interest on drawings may arise:

Case 1: When Rate of Interest on Drawings is given in %

Interest on Drawings is calculated on flat rate irrespective of period.

Case 2: When Rate of Interest on Drawings is given in % p.a.

1. When date of Drawing is not given

$$\text{Interest on Drawing} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{6}{12}$$

Note: Interest is calculated for a period of 6 months, we assume drawings have been done evenly during the year, that is why we take average six months tenure.

2. When date of Drawings is given

$$\text{Interest on Drawing} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{\text{Time left after drawings (in months)}}{12}$$

Case 3: When different amount are withdrawn on different dates:

We have the following two methods to calculate the amount of interest on Drawing:

1. Simple Interest Method

In this method, interest on drawing is calculated for each amount of drawing individually on the basis of periods for which it remained withdrawn till the close of accounting period.

2. Product Method

In this method, the amounts of drawings are multiplied by the period for which it remained withdrawn during the period; Thereafter the products are added and interest is calculated on the total of products so arrived at for one month. The advantage of this system is that separate calculations are not required each time.

We can explain the above mentioned two methods with the help of an example.

Month	Date	Drawings Amount
May	1	12000
July	31	6000
September	30	9000
November	30	12000
Janurary	1	8000
March	31	7000

Interest on drawings is to be charged @ 9% p.a

SIMPLE METHOD

DATE	AMOUNT	PERIOD	INTEREST @9%
1 MAY	12000	11	990
31 JULY	6000	8	360
30 SEP	9000	6	405
30 NOV	12000	4	360
1 JAN	8000	3	180
31 MAR	7000	0	00

TOTAL	54000		2295
--------------	--------------	--	-------------

PRODUCT METHOD

DATE	AMOUNT	PERIOD	PRODUCTS
1 MAY	12000	11	132000
31 JULY	6000	8	48000
30 SEP	9000	6	54000
30 NOV	12000	4	48000
1 JAN	8000	3	24000
31 MAR	7000	0	00
TOTAL	54000		306000

Interest = Total of products * 9/100* 1/12= 306000*9/100*1/12 = Rs 2295/-.

Case 4: When an equal amount is withdrawn regularly

Interest on Drawing can be calculated using either Product Method or Direct Method (i.e. Short Cut Method)

Direct Method will be used only if all the following three conditions are satisfied:

1. Amount should be same throughout the period
2. Date of Drawings should be same throughout the period
3. Drawings should be made regularly without any gap.

$$4. \text{ Interest on Drawing} = \text{Total Drawings} \times \frac{\text{Rate}}{100} \times \frac{T}{12}$$

T = Time (in months) for which interest is to be charged

$$T = \frac{\text{Time left after first drawing} + \text{Time left after last drawing}}{2}$$

Value of T under Different circumstances will be as under:

	Quarterly		
--	-----------	--	--

Monthly Drawings for 12 Months	Drawings for 12 Months	Half yearly Drawings for 12 Months	Monthly Drawings for 06 Months (last 6 months)
6.5(beginning of the month)	7.5 (beginning of every quater)	9 (beginning of every month for six month in the beginning of 6 months)	3.5(beginning of the month for last six month)
6(middle of every month)	6(middle of every quater)	6 middle of every month for six month in the beginning of 6 months)	3(middle of the month for last six month)
5.5(end of every month)	4.5(end of every quater)	3 (end of every month for six month in the beginning of 6 months)	2.5(end of the month for last six month)

INTEREST ON PARTNERS LOAN

If a partner has given loan to the firm, he is entitled to receive interest on such loan at an agreed rate.

It is a charge against profits. It is provided irrespective of profits or loss. It will also be provided in the absence of Partnership Deed @ 6% per annum.

The following entries are passed to record the interest on partner's loan

1. For allowing Interest on loan:

Interest on Partner's Loan A/cDr.

To Partner's Loan A/c

(Being interest on loan allowed @ % p.a.)

2. For transferring Interest on Loan to Profit and Loss A/c:

Profit and Loss A/cDr.

To Interest on Loan A/c

(Being Interest on loan transferred to P & L A/c)

It is always DEBITED to Profit and Loss A/c

Rent Paid to Partner.

Rent paid to a partner is also a charge against profits and it will also be

DEBITED to Profit and Loss A/c

Note:

$$\begin{aligned}\text{Interest on A's Loan} &= \text{Loan Amount} \times \frac{\text{Rate}}{100} \times \frac{\text{Time left after loan taken}}{12} \\ &= 2,00,000 \times \frac{6}{100} \times \frac{05}{12} = \text{Rs. } 5,000\end{aligned}$$

PAST ADJUSTMENTS

If, after preparation of Final Accounts of firm, it is found that some errors or commission in accounts has occurred than such errors or omissions are rectified in the next year by passing an adjustment entry.

A statement is prepared to ascertain the net effect of such errors or omissions on partner's capital/current accounts in the following manner.

Statement showing adjustment

Particulars	A (Rs.)	B (Rs.)	C (Rs.)
A Amount to be given credited			
Interest on Capital (Not allowed or provided at a lower rate)			
Partner's Salary or Commission etc. (Omitted to be recorded)			
Actual Profits (To be distributed in correct ratio)			
Total A			

B. Amount already given to be taken back now debited * Interest on Capital (If given at a higher rate) * Interest on Drawings (If not charged) * Profits already distributed in wrong ratio (debited now)			
Total B			
Net Effect (A-B)	+/-	+/-	+/-

+ Indicates Amount to be Credited to Partner's Capital Account – Indicates Amount to be Debited to Partners Capital Account

Journal

Date	Particulars	LF.	Debit(Rs.)	Debit(Rs.)
	Partners Capital A/C Dr. (Amount to be Debited) To Partners' Capital A/c (Amount to be Credited) (Being adjustment entry passed)			

During Past Adjustment it is not compulsory that capital accounts of all partners are affected. More than one partners Capital Account may be debited or credited but amount of debit & credit should be equal.

GUARANTEE OF PROFITS TO A PARTNER

Guarantee is an assurance given to the partner of the firm that at least a fixed amount shall be given to him/her irrespective of his/her actual share in profits of the firm. If actual share in profits is less than the guaranteed amount in that case the deficit amount shall be borne either by the firm or by any partner as the case may be or as may have been decided by a na agreement.

Note:

Guarantee to a partner is given for minimum share in profits. If the actual share in profits is more than the minimum share in profits, then the actual profits will be allowed to the partner.

Case: 1. When guarantee is given by FIRM (i.e. by all the Partners of the firm)

1. If share in actual profits is less than the guaranteed amount then. Guaranteed amount to a partner is first written off against the profits and then,
2. Remaining profits are distributed among the remaining partners in the remaining ratio.

Case: 2. When guarantee is given by a partner or partners to another partner.

1. Calculate the share in profits for the partner to whom guarantee is given.
2. If share in profits is more than the guaranteed amount, distribute the profit as per the profit and loss sharing ratio in usual manner.
3. If share in profits is less than the guaranteed amount, find the difference between the share in profits and the guaranteed amount and the difference known as deficiency.

Deficiency is contributed by the partner or partners who guaranteed in certain ratio and subtracted from his or their respective shares.

Goodwill Nature And Valuation

Goodwill is good name or the reputation of the business, which is earned by a firm through the hardwork and honesty of its owners. If a firm renders good service to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future.

Thus, goodwill is the value of the reputation of a firm which enables it to earn higher profits in comparison to the normal profits earned by other firms in the same trade.

Features of Goodwill

- 1. It is an intangible asset :** Goodwill cannot be seen or touched, it does not have any physical existence, thus it belongs to the category of intangible assets such as patents, trade marks, copy rights, etc.
- 2. It is a valuable asset**
- 3. It is helpful in earning excess profits.**
- 4. Its value is liable to constant fluctuations :** While goodwill does not depreciate, its value is liable to constant fluctuation, its value is liable to constant fluctuations. It is always present as a silent asset in a business where there are super profits (i.e. more than the normal) but declines in value with the decline in earnings.
- 5. It is valuable only when entire business is sold :** Goodwill cannot be sold in part. It can be sold with the entire business only. The only exception is at the time of admission or retirement of the partner.
- 6. It is difficult to place an exact value on goodwill :** This is because its value may fluctuate from time to time due to changing circumstances which are internal and external to business.

Goodwill is divided into two categories.

I. Purchased Goodwill: Purchased goodwill means goodwill for which a consideration has been paid e.g. when business is purchased the excess of purchase consideration of its net assets i.e. (Assets – Liabilities) is the Purchased Goodwill. It is separately recorded in the books because as it is purchased by paying in form of cash or kind.

Characteristics

- (i) It arises on purchase of a business or brand.
- (ii) Consideration is paid for it so it is recorded in books.
- (iii) Shown in balance sheet as an asset.
- (iv) It is amortised (depreciated).
- (v) Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

II. Self-generated Goodwill also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

Features

- (i) It is generated internally over the years.
- (ii) A true cost cannot be placed on this type of goodwill.
- (iii) Value depends on subjective judgment of the value.
- (iv) **As per Accounting Standard 26(Intangible Asset)**, it is not recorded in the books of accounts because consideration in money or money's worth has not been paid for it.

Factors Affecting the Value of Goodwill

1. Efficient management : If the business is run by experienced and efficient management, its profits will go on increasing, which results in increase in the value of goodwill.

2. Quality of products : If the firm is supplying good quality of products, then the customer will come again and again for the same and thus will create the goodwill and brand name for the same.

3. Location of business : If the business is located at a convenient or prominent place, it will attract more customers and therefore will have more goodwill.

4. The Longevity of the business : An older business is better known to its customers, therefore it is likely to have more goodwill. When a business enterprise has built up good reputation over a period of time, the number of customers will be more in comparison to the customers of new entrants. Number of customers is an indicator of profit earning capacity of a business.

5. Monopolistic and other Rights : If a business enjoys monopoly market, it will have assured profits. Similarly, if it holds some special rights such as patents, trade marks, copyrights or concessions, etc, it will have more goodwill.

6. Other factors:

- (i) Good industrial relations.
- (ii) Favourable Government regulations
- (iii) Stable political conditions
- (iv) Research and development efforts
- (v) Effective advertising to establish brand popularity
- (vi) Popularity of product in terms of quality.

Need for Valuing Goodwill: Whenever the mutual rights of the partners changes the party which makes a sacrifice must be compensated. This basis of compensation is goodwill so we need to calculate goodwill.

Mutual rights change under following circumstances

1. When profit sharing ratio changes
2. On admission of a partner
3. On Retirement or death of a partner
4. When amalgamation of two firms taken place

5. when partnership firm is sold.

Method of valuation of goodwill :

It is very difficult to assess the value of goodwill, as it is an intangible asset. In case of sale of a business, its value depends on the mutual agreement between the seller and the purchaser of the business. Usually, there are three methods of valuing goodwill:

1. average profit method
2. Super profit method
3. Capitalization method

Average Profit Method

This is a very simple and widely followed method of valuation of goodwill. In this method, goodwill is calculated on the basis of the number of past years. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill.

Formula for calculation of goodwill

Goodwill = Average Profits \times Number of years of purchase

Number of years of purchase means for how many years the firm will earn the same amount of profits in future.

Average Profits = Total Profits/Number of years

A buyer always wants to estimate the future profits of a business. Future profits depend upon the average performance of the business in the past. Past profits indicate as to what profits are likely to accrue in the future. Therefore the past profits are averaged. But before calculating the average profits, the profits earned in the past must be adjusted in the light of future expectations and the following factors should be taken into account while calculating the average profits:

(i) Abnormal income of a year should be deducted out of the net profit of that year.

(ii) Abnormal loss of a year should be added back to the net profit of that year.

(iii) Income from investments should be deducted out of the net profits of that year, because this income is received from outside the business.

Weighted Average Profit Method: This method is a modified version of average profit method. In this Method each year's profit is assigned a weight. The highest weight is attached to profit of most recent year.

Eg: 2011-1, 2012-2, 2013-3, 2014-4.

Each year profits are multiplied by assigned weights. Products are added & divided by total number of weights. Weighted average is multiplied by agreed Number of years of Purchase.

$$\text{Weighted Average Profit} = \frac{\text{Total product of profits}}{\text{Total of weights}}$$

Goodwill = Weighted Average Profit \times No. of years of purchase.

Weighted average profit method is considered better than the simple average profit method because it assigns more weightage to the profits of the latest year which is more likely to be earned in future. This method is preferred when profits over the past years have been continuously rising or falling.

Super profit Method : In this method goodwill is calculated on the basis of surplus (excess) profits earned by a firm in comparison to average profits earned by other firms. If a business has no anticipated excess earnings, it will have no goodwill. Super Profit are the excess of actual profit over normal profits. Where Normal profits are profits earned by similar business.

If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwill is calculated on the basis of Super profit due to future expectations of earning capacity of the firm.

Goodwill is calculated by the formula

Goodwill = Super Profit \times Number of years of purchase

Super Profit = Average profit - Normal profits

$$\text{Normal Profit} = \text{Investment (Capital Employed)} \times \frac{\text{Normal Rate of Return}}{100}$$

Capital Employed = Capital + Free Reserves – fictitious Assets (if any), or

All Assets – (Goodwill, fictitious assets and non-trade Investment) – Outsider's Liabilities

Capitalised Method Under this method, goodwill can be calculated in two ways:

(A) Capitalisation of Average Profit Method: Under this method first of all we calculate the average profits and then we assess the capital needed for earning such average profits on the basis of normal rate of return. Such capital is also called capitalised value of average profits. It is calculated as under.

$$\text{Capitalised value of the firm} = \frac{\text{Average profits} \times 100}{\text{Normal rate of return}}$$

Goodwill is calculated by deducting the actual capital employed in business from the capitalised value of average profits. There will be no goodwill if the actual capital employed in the business exceeds or equals the capitalised value of the average profits.

Net Assets or Capital employed = Total assets – Outside liabilities

Goodwill = Capitalized value of average profits – Capital Employed

(B) Capitalisation of Super Profit Method: Under this method first of all we calculate the super profits and then we assess the capital needed for earning such super profits on the basis of normal rate of return. Such capital is actually the amount of goodwill. Super profits are calculated in the same manner as calculated in super profits method.

Goodwill of the firm = Super Profits * 100 / Normal rate of return.