

- According to Sec. 4 of the Indian Partnership Act, 1932, "**Partnership** is the relation between two or more persons who have agreed to share the profits of a business carried on by all or any of them acting for all".
- **Features or Characteristics of Partnership:** The main features of a partnership:
 - (i) There must be at least two persons to form a partnership.
 - (ii) There must be an agreement to form a partnership
 - (iii) Partnership is to be formed for the purpose of carrying on some business.
 - (iv) The business to be carried on by the partners must be legal.
 - (v) The agreement must be to share the profits of the business.
 - (vi) Business can be carried on by all or any of them acting for all.
- **Partnership deed** is the written agreement, which specifies the terms and conditions that govern the partnership. The deed contains the following particulars:
 - (i) Name and address of the firm.
 - (ii) Names and addresses of the partners.
 - (iii) Address of the principal place of business.
 - (iv) Nature of business that the firm proposes to do.
 - (v) Date of commencement of partnership.
 - (vi) Capital contribution by each partner.
 - (vii) Rate of Interest on loan taken by partners from the firm and vice-versa.
 - (viii) Rate of interest, if any, to be allowed on capitals of partners.
 - (ix) Rate of interest, if any, to be charged on drawings of partners.
 - (x) Profit-Sharing Ratio among the partners.
 - (xi) Salaries, commission, etc, if payable to any partner.
 - (xii) Settlement of Accounts in case of retirement or death or dissolution of the firm.
 - (xiii) Valuation of Assets in case of its reconstitution.
 - (xiv) Accounting Period, i.e. date on which accounts shall be closed every year.
 - (xv) Rights and Duties of Partners
 - (xvi) Rules regarding operation of Bank Accounts
 - (xvii) Settlement of Disputes among the partners.
 - (xviii) Mode of auditor's appointment, if any.
- **Partnership Deed is an Important Document Because:**
 - (i) It regulates the rights, duties and liabilities of each partner.
 - (ii) If any dispute arises between the partners, then it may be settled by referring partnership deed as it act as a good evidence in the court.
- **Provisions in Absence of a Partnership Deed:**
 - (i) Profit and Losses are to be shared equally.
 - (ii) No Interest on capital to be allowed.
 - (iii) No Interest on drawings to be charged.
 - (iv) Interest on Loan is payable @ 6% per annum even if there are losses.
 - (v) No Salary / Commission is to be paid to any partner for taking part in the conduct of business.
- **Profit and Loss Appropriation Account** is prepared to show the distribution of firm's net profit among the partners. It is an extension of the Profit and Loss Account.
- **Capital Accounts:** A partnership firm maintains separate Capital Account for each partner. Partners' Capital Accounts may be maintained in two manners:
 - (i) **Fixed Capital Accounts:** Under this method, two accounts (Capital Account and Current Account) are maintained for each partner. The transactions relating to introduction or withdrawal of capital are recorded in the Capital Account. Other transactions like interest on capital, drawings, salary, commission, share of profit or loss, etc. are recorded in the Current Account.
 - (ii) **Fluctuating Capital Accounts:** Under this method, only one account (Capital Account) is maintained for each partner. All the transactions relating to a partner (like profit or loss, drawings, interest on capital, salary, etc.) are also recorded in this Capital Account.

- **Interest on drawings:** It is to be calculated with reference to the time period for which the money was withdrawn.
 - (i) Interest is charged only if there is a provision in the partnership deed.
 - (ii) It is calculated at a rate agreed in the deed.
 - (iii) As interest on drawings is a gain to the firm, it is credited to the Profit and Loss Appropriation Account and debited to Partners' Capital Accounts (or Current A/c in case of Fluctuating Capital Method).
- **Interest on Capital:** It is allowed to the partners to compensate them for contributing capital to the firm.
 - (i) Interest is allowed only if there is a provision in the partnership deed.
 - (ii) It is to be calculated on time basis after taking into consideration the withdrawal or introduction of capital.
 - (iii) As interest is an appropriation out of profits, it is provided through the Profit and Loss Appropriation Account instead of the Profit and Loss Account (Except when it is a charge against profits)
- **Interest on Loan:** Partner is entitled to receive interest on loan at an agreed rate of interest. In absence of deed or when deed is silent, then according to provisions of the "Indian Partnership Act, 1932", partner shall get interest @ 6% p.a. Such interest on loan is a charge against profits.
- **Past Adjustments:** If after preparation of final accounts, it is found that certain items have been omitted by mistake or have been wrongly treated, then adjustment is made directly in the partners' capital or current accounts, by passing an adjustment entry. The adjustment entry is made at the beginning of the next year.
 - (i) Debit Capital/Current Account (as the case may be) of the partner who has been credited in excess; and
 - (ii) Credit Capital/Current Account of the partner who has been debited in excess.
- **Guarantee of Profits:** Guarantee is an assurance that an existing partner or an incoming partner will not get his share of profit less than the guaranteed amount. Such a guarantee may be given either by:
 - (i) All other partners in an agreed ratio; (ii) Any one of the remaining partners; (iii) Two or more of the remaining partners (but not all of the remaining partners)

- **Goodwill** is the value of the reputation of a firm in respect of the profits expected in future over and above the normal profits earned by other similar firms belonging to the same industry.

• **Characteristics or Features of Goodwill**

- (i) It is an intangible asset and not a fictitious asset.
- (ii) It enables the firm to earn profits in excess of normal profit.
- (iii) It cannot be sold in part or in isolation.
- (iv) It cannot have an exact cost as its value fluctuates from time to time.
- (v) Its value is based on subjective judgement of the valuer.

• **Factors Affecting the Value of Goodwill:** The main factors, which influence value of goodwill are:

1. **Efficiency of Management:** Efficient management enables the firm to earn higher profits, which increases the value of goodwill.
2. **Location:** Better location attracts more customers resulting in increase in sales and profits which in turn, results in increase in the value of goodwill.
3. **Nature of Business:** The firm that produces high value added products or has stable demand is able to earn more profit and more goodwill.
4. **Favourable Contracts:** If firm has favourable contracts with other reputed firms, then value of its goodwill is more.
5. **Special Advantages:** If a firm enjoys special advantages like patents, trademarks, etc., then the firm enjoys higher value of goodwill.
6. **Market Conditions:** The monopoly condition or limited competition enables the concern to earn high profits which leads to higher value of goodwill.
7. **Time Factor:** Firm which is running for many years on profitable lines has more goodwill as compared to a firm which has been just established.
8. **Other Factors** like good industrial relations, effective advertising, research and development efforts also influence the value of goodwill.

• **Classification of Goodwill:** Goodwill can be classified into two categories:

1. **Purchased Goodwill:** Purchased goodwill arises when a business unit is purchased by another business concern and the purchase price paid is in excess of the value of net assets (i.e. Assets - Liabilities) acquired.
2. **Self-Generated Goodwill:** It is an internally generated goodwill which arises from a number of attributes that a running business possesses.

• **Need for Valuation of Goodwill:** The need for valuation of non-purchased goodwill arises in the following circumstances:

1. Change in the profit-sharing ratio among the existing partners
2. Admission of new partner
3. Retirement and Death of a partner
4. Dissolution of a firm involving sale of business as a going concern
5. Amalgamation of partnership firms

• **Methods of Valuation of Goodwill:** Some important methods to calculate goodwill of a firm are:

1. **Average Profit Method:** Under this method, past profits of a number of years are totaled up and average profit is found out (after adjusting for abnormal items, if any). This average profit is multiplied by an agreed number of years' purchase to arrive at the value of goodwill.
2. **Super Profit Method:** Under this method, goodwill is calculated on the basis of super profits (excess of actual or average profit over normal profit). Goodwill is determined by multiplying Super Profit by a certain number of years' purchase as agreed by the partners.
3. **Capitalisation Method:** Under this method, goodwill can be calculated by two methods: (i) **Capitalisation of Average Profit Method:** Goodwill is determined by subtracting the actual capital employed (net assets) in the business from the capitalised value of the average profits. (ii) **Capitalisation of Super Profit Method:** Goodwill is ascertained by capitalising the super profits on the basis of Normal Rate of Return.

Average Profit Method

Under this method, past profits of a number of years are taken into consideration. Such profits are totaled up and their average is found out. The average profit is then multiplied by an agreed number of years' purchase (such as 1, 2, 3, etc.) to arrive at the value of goodwill.

Steps involved in Valuation of Goodwill

- Step 1: Calculate Normal Profit or loss for each of the past year, after adjusting any abnormalities *(Refer the Table: Calculation of Adjusted Profits)*.
- Step 2: Calculate Total Profits by adding past profits of each year.
- Step 3: Calculate Average Profit as follows:

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

- Step 4: Goodwill = Average Profits × Number of Years' Purchase

Example for Better Clarity: Suppose goodwill of a firm is to be valued at 3 years' purchase of average profits of last 5 years. The profits of last 5 years are: ₹ 20,000, ₹ 18,000, ₹ 12,000, ₹ 16,000 and ₹ 14,000.

The goodwill of the firm will be calculated as:

$$\text{Total Profits} = 20,000 + 18,000 + 12,000 + 16,000 + 14,000 = ₹ 80,000$$

$$\text{Average Profit} = \frac{\text{Total Profits}}{\text{Number of Years}} = \frac{80,000}{5} = ₹ 16,000$$

$$\text{Goodwill} = \text{Average Profits} \times \text{Number of Years' Purchase} = 16,000 \times 3 = ₹ 48,000$$

Calculation of Normal Profits or Adjusted Profits

To calculate the normal profit, any abnormal gain is deducted out of net profit of that year and abnormal loss is added back to the net profit of that year. Let us understand this with the help of following table:

Calculation of Adjusted Profits		(₹)
Profit or Loss (Given) of Past Year <i>(before Adjustments)</i>		....
Add: (i) Abnormal losses <i>(like loss by fire, theft, earthquake, etc.)</i>		....
(ii) Loss on sale of fixed assets <i>(as sale of fixed assets is not a normal business activity)</i>		....
(iii) Under valuation of Closing stock <i>(as it would have reduced the profits)</i>		....
(iv) Over valuation of Opening stock <i>(as it would have reduced the profits)</i>		....
(v) Other Non-recurring expenses <i>(as such expenses are not expected in future)</i>		....
(vi) Capital expenditure treated as an expense <i>(like purchase of machinery treated as expense)</i>		....
Less: (i) Abnormal Gains <i>(like profit from speculative activities)</i>		(....)
(ii) Income from Non-Trade Investments <i>(as it is not related to normal business activities)</i>		(....)
(iii) Profits on sale of fixed assets <i>(as sale of fixed assets is not a normal business activity)</i>		(....)
(iv) Over valuation of closing stock <i>(as it would have increased the profits)</i>		(....)
(v) Under valuation of opening stock <i>(as it would have increased the profits)</i>		(....)
(vi) Other Non-recurring incomes <i>(as such incomes are not expected in future)</i>		(....)
(vii) Remuneration to partners, if it is already not deducted <i>(as it is to be paid in future years)</i>		(....)
(viii) Any other future expenses, like insurance premium <i>(as it is to be paid in future years)</i>		(....)
Adjusted Profits		....

Weighted Average Profit Method

This method is an extension of average profit method. If profits show a rising or falling trend, then weighted average profit method is preferred as it gives more weightage to the latest profit which is likely to be maintained in the future by the firm.

- If the profits show an increasing trend, then weights like 1, 2, 3, 4, etc. may be used.
- If profits are showing decreasing trend, then weights like 4, 3, 2, 1, etc. may be used.

However, weights to be used for calculating weighted profits are generally given in the question.

Steps involved in Valuation of Goodwill

Step 1: Calculate Normal Profit or Loss for each of the past year, after adjusting any abnormalities.

Step 2: Calculate Weighted Profit for each of the past years by multiplying normal profit by the respective weight.

Step 3: Calculate the total of weights and total of weighted profits

Step 4: Calculate Weighted Average Profits as follows:

$$\text{Weighted Average Profit} = \frac{\text{Total of Weighted Profits}}{\text{Total of Weights}}$$

Step 5: Goodwill = Weighted Average Profits × Number of years' purchase.

Capital Employed

Capital employed represents the amount invested in the business. For the purpose of valuation of goodwill, capital employed can be calculated by any one of the following two methods:

- (i) Liability Side Approach: Capital Employed (CE) is calculated as:
$$CE = \text{Capital} + \text{Free Reserves} - \text{Fictitious Assets} - \text{Non-trade investments}$$
- (ii) Assets Side Approach: Capital Employed is calculated as:
$$CE = \text{All Assets (except goodwill, fictitious assets and non-trade investments)} - \text{Outsiders' Liabilities.}$$

Let us understand the concept of capital employed with the help of following Balance Sheet.

Liabilities	Amt. (₹)	Assets	Amt. (₹)
Partners' Capital	Fixed Assets	.....
Reserves	Current Assets	.....
External Liabilities	Non-trade investments	.....
	Fictitious Assets	.....

Capital Employed = Partners' Capital + Reserves – Non-trade investments – Fictitious Assets
Or

Capital Employed = Fixed Assets + Current Assets – External Liabilities

Steps involved in Valuation of Goodwill

Step 1: Calculate Average Capital Employed of the business as under:

$$\frac{\text{Opening Capital Employed} + \text{Closing Capital Employed}}{2}$$

Step 2: Calculate Normal Profit on capital employed as under:

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

Step 3: Calculate Actual Profit or average profit.

Step 4: Calculate Super Profit, i.e. Actual or Average Profit – Normal Profit

Step 5: Goodwill = Super Profit × Number of Years' Purchase

Difference Between Average Profit and Super Profit

Basis	Average Profit	Super Profit
Meaning	Average profit is the average of profits of past few years	Super profit is the excess of average profit over normal profit
Normal Rate of Return	It is not considered while calculating the average profit.	It is considered while calculating the super profit.
Average Capital Employed	It is not considered while calculating the average profit.	It is considered while calculating the super profit.
Relevance of Valuing Goodwill	Average Profit is needed to value goodwill under all the three methods.	Super Profit is needed to value goodwill under Super Profit Method and Capitalisation of Super Profit Method only.

Capitalisation Method

Under this method, goodwill can be calculated by two methods:

- (i) Capitalisation of Average Profit Method
- (ii) Capitalisation of Super Profit Method

Capitalisation of Average Profit Method

Under this method, the value of goodwill is determined by subtracting the actual capital employed (net assets) in the business from the capitalised value of the average profits.

Steps involved in Valuation of Goodwill

Step 1: Calculate the value of Net Assets as on the date of valuation of Goodwill:
Net Assets = All Assets (except goodwill, fictitious assets and non-trade investments) - Outsiders' Liabilities

Step 2: Calculate Average Profit of agreed number of past years.

Step 3: Calculate capitalised value of average profits as under:

$$\text{Capitalised Value of Average Profits} = \frac{\text{Average Profit} \times 100}{\text{Normal Rate of Return}}$$

Step 4: Goodwill = Capitalised value of Average Profits - Net Assets

Let us understand determination of Goodwill by Capitalisation of Average Profit Method with the help of following illustrations.

Illustration 15. A business has earned average profits of ₹ 1,00,000 during the last few years and the normal rate of return in a similar business is 10%. Determine the value of goodwill by capitalisation of average profit method, if net assets of the business are ₹ 8,20,000.

Solution:

$$\text{Capitalised Value of Average Profits} = \frac{\text{Average Profit} \times 100}{\text{Normal Rate of Return}}$$

$$\text{Capitalised Value of Average Profits} = \frac{1,00,000 \times 100}{10} = ₹ 10,00,000$$

$$\text{Goodwill} = \text{Capitalised Value of Average Profits} - \text{Net Assets}$$

$$\text{Goodwill} = 10,00,000 - 8,20,000 = ₹ 1,80,000$$

Capitalisation of Super Profit

Under this method, goodwill is ascertained by capitalising the super profits on the basis of Normal Rate of Return. In other words, the capitalised value of super profit is termed as goodwill. For example, if a firm earns super profit of ₹ 12,000 and normal rate of return is 10%, then goodwill will be:

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}} = 12,000 \times \frac{100}{10} = ₹ 1,20,000$$

Steps involved in Valuation of Goodwill

- Step 1: Calculate the capital employed of the business as under:
Capital Employed or Net Assets = Total Assets (except goodwill) – Outside Liabilities.
- Step 2: Calculate the normal profit on capital employed as under:
$$\text{Normal Profit} = \text{Average Capital Employed} \times \frac{\text{Normal Rate of Return}}{100}$$
- Step 3: Calculate Average Profit of agreed number of past years.
- Step 4: Calculate Super Profit as: Super Profit = Average Profit – Normal Profit
- Step 5: Calculate Goodwill as:

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