

SUPER PROFIT METHOD

For goodwill it is said that it is value of anticipated excess earnings and valuation of future earnings. In context to this statement future earnings are given more importance than past profits and because of this instead of weighted average profits super profit method is in much prevalence. In super profit method super profits are the main base for valuation of goodwill.

Meaning of Super Profit:

Super profits refer to excess of actual average profits over normal profits of an enterprise. In simple words super profits refer to those profits which an enterprise earns in excess of the profits of which a either similar enterprise is earning In brief.

SUPER PROFIT =

Actual Average profit - Normal profit

Calculation of Normal Profits

Normal profits are calculated by the formulae given below----

Capital employed or average capital employed x normal rate of return /100

Normal rate of return: Normal rate of return is the rate which an investor expects to earn on capital employed in specific business. Sum of pure rate of return and risk rate of return is known as normal rate of return.

CAPITAL EMPLOYED

Capital invested in business is known as Capital Employed.

For valuation of goodwill meaning of capital employed is as follows:

Capital Employed= Fixed Assets + Current Assets + Trade Investment (excluding Goodwill, external investment, fictitious assets like preliminary expenses, discount on issue of shares and debentures)

/less External liabilities (debentures, loans, current liabilities)

Liabilities side approach:

Capital Employed =Paid up equity and preference share capital (participating) + capital reserve + revenue reserve + credit balance of profit and loss a/c + profit on revaluation of assets and liabilities - fictitious assets, goodwill - non trading investment - trading loss - loss on revaluation

Goodwill: If amount of goodwill is already given in balance sheet on asset side it will not be added as we are calculating goodwill only. Although some Authors are the view that it should be added but in our opinion it is not correct.

Investment: Following are the important point in relation to investments-

- (a) Non-Trading investments or external investments are not to be included in assets. In such case income from these investment should also be deducted from profits
- (b) Internal or Trade Investments (Which have been purchased for the progress of business) are to be added to assets on revalued price or at value given in balance sheet while calculating capital employed and income from these investments is added to the profits.
- (c) In question if only word investment is given and no other information is given through which it can be ascertained whether they are trade Investment or Non-Trade investment then they should be treated as **non-trade investment** and are to be left over. Foot Note should be given in this regard.

Fictitious Assets: Fictitious or artificial assets (such as preliminary expenses, discount on issue of shares and debentures deferred expenditure, debit balance of profit and loss account (loss)) are not to be added to assets while calculating capital employed.

External Liabilities: Debentures, Long Terms loans, creditors, bills payable, bank overdraft, outstanding expenses, income tax etc are included in external liabilities. These above mentioned external liabilities are deducted from the total of assets

(Equity share capital, capital reserve, undistributed profits, retained earnings etc are treated as internal liabilities)

Preference Share Capital :

While calculating capital employed preference share capital required special attention From this point of view Preference shares are of two types

- (i) Participating
- (ii) Non-Participating

If preference shares are of **participating** nature then they are not to be deducted from total value of assets as external liabilities, while calculating capital employed. In contrary to this if preference shares are of **non participating** nature then these are treated as external liabilities and are deducted from total of assets.

Average capital employed: Average capital employed is calculated in the following manner.

(i) Average capital employed =
(Capital employed at the begining+ Capital employed at the end)^{1/2}

(ii) Average capital employed =
Capital employed at the end - $\frac{1}{2}$ profit of current year

Meaning of profit earned during the year: Profit earned durning the year ef so that profit which has been earned after deducting income from Non-Trade investmen an interest on long term loan Interest on debentures + Remuneration to owners and Income Tax.

Why average capital is used: Most of the academicians are of the view while calculating goodwill average capital should be used. According to them profits wamed through out the year and ploughing back or profits keeps on taking place and m capital is utilised to carn more profits in coming months.

Important Point: (1) For valuation of goodwill some accountants use capital employed or net capital employed and some of them use average capital employed.. It is advised to students that they calculate goodwill according to instructions given in question. If no information has been given in question than student should give a **foot note** regarding the method (Average capital employed or capital employed) they have used.

(2) If **proposed dividend** has been given on liability side in balance sheet of company then amount of proposed dividend is added to net profit. Half of such profit deducted from capital employed. If organisation has paid advance incom tax this amount is also deducted from the profits.