concept no.2

Average Profit Method



The **Average Profit Method** is one of the simplest ways to value goodwill. In this method, we calculate the value of goodwill by multiplying the average estimated profit (or average future profit) with the number of years of purchase. There are two Variants of Average Profit Calculation:



- **Simple Average:** In this approach, we calculate the goodwill by multiplying the straightforward average profit with the agreed-upon number of years of purchase.

***Goodwill** = Average Profit × Number of Years of Purchase*



- **Weighted Average**: Here, we assign weights to the profits of each year, giving more weightage to recent years. The weighted average profit is then multiplied by the number of years of purchase.

***Goodwill** = Weighted Average Profit × Number of Years of Purchase*

COMMERCE RAMA

concept no.2

Questions:

Q.1) The goodwill of a firm is valued at 4 years' purchase of average profits of last five years. The profits of the last five years were :

2012-13	**2,60,000**
2013-14	2,00,000
2014-15	-3,00,000
2015-16	4,00,000
2016-17	3,00,000

Calculate the amount of goodwill.

[ANS: Goodwill = ₹6,88,000]

COMMERCE RAMA

concept no.2

Questions:

Q.2). X purchased the business of Y from 1st April, 2023. For this purpose goodwill is to be valued at 100% of the average annual profits of the last four years. The profits shown by business for the last four years were :

Year ended	(₹)
31 st March, 2020	1,00,000
31 st March, 2021	1,50,000
31 st March, 2022	1,50,000
31 st March, 2023	2,00,000

Calculate the value of goodwill.

[ANS: Goodwill = 1,50,000]

COMMERCE RAMA

ELITE COMMERCE MINDS
COMMERCE RAMA

concept no.2

Questions:

Q.3) A, B and C are partners in a firm sharing profits and losses in the ratio of 3:2:1. They decide to take D into partnership for l/4th share on 1st April, 2022. For this purpose, goodwill is to be valued at 3 times the average annual profits of the previous four or five years whichever is higher. The agreed profits for goodwill purpose of the past five years are as follows :

Year ending on 31 st March 2018	1,30,000
Year ending on 31st March 2019	1,20,000
Year ending on 31st March 2020	1,50,000
Year ending on 31 st March 2021	1,10,000
Year ending on 31st March 2022	2,00,000

Calculate the value of Goodwill.

[Ans. Goodwill ₹4,35,000]

COMMERCE RAMA

concept no.2

Questions:

Q.4) The profits earned by a firm during the last four years were as follows :

Year ended 31st March	Profits (₹)
2018	80,000
2019	1,00,000
2020	1,10,000
2021	1,50,000

Calculate the value of goodwill on the basis of three year's purchase of weighted average profits. Weights to be used are 1,2, 3 and 4 respectively to the profits for 2018, 2019, 2020 and 2021.

[Ans. Value of Goodwill ₹ 3,63000.]

COMMERCE RAMA

END OF CONCEPT-2

concept no.

3 Average Profit Method when Past Adjustments are to be Made