concept no.3

Average Profit Method when Past Adjustments are to be Made

Before the calculation of 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.

COMMERCE RAMA

concept no.3

Question

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 :

Year	Profit (₹)
2013-14	: 2,00,000
2014-15	: (3,00,000)
2015-16	: 4,50,000 (including an abnormal gain of ₹50,000)
2016-17	: 3,50,000 (after charging an abnormal loss of ₹90,000)
2017-18	: 2,60,000

Calculate the amount of goodwill.

[ANS: Goodwill = ₹8,00,000]

concept no.3

Question

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	Profit	1,00,000 (after debting loss of stock by fire ₹50,000)
31 st March, 2021	Loss	1,50,000 (includes voluntary retirement compensation paid ₹80,000)
31 st March, 2022	Profit	1,50,000
31 st March, 2023	Profit	2,00,000

Verification of books of accounts revealed the following :

(i) During the year ended 31 st March, 2021, a machine got destroyed in accident and ₹60,000 was written off as loss in Profit & Loss Account.

(ii) On 1st July 2021, Two Computers costing ₹40,000 each were purchased and were debited to Travelling Expenses Account on which depreciation is to be charged @ 10% p.a. on Straight Line Method.

Calculate the value of goodwill.

[ANS: Goodwill = ₹ 1,39,000]

concept no.3

Question

Q.3).A and B are partners sharing profits and losses in the ratio of 3 : 2. They agree to take C into partnership for l/3rd share. For this purpose, goodwill is to be valued at two year's purchase of the average profit of last four years which were as follows :

	₹
Year ending on 31st March 2019	50,000 (Profit)
Year ending on 31st March 2020	1,20,000 (Profit)
Year ending on 31st March 2021	1,80,000 (Profit)
Year ending on 31st March 2022	70,000 (Loss)

On 1st April, 2021 a Motor bike costing ₹50,000 was purchased and debited to travelling expenses account, on which depreciation is to be charged @ 20% p.a.

The firm also paid an annual insurance premium of ₹20,000 which had already been charged to Profit and Loss Account for all the years.

Calculate the value of goodwill.

[ANS: Goodwill = ₹ 1,60,000]

COMMERCE RAMA

concept no.3

Question

Q.4) Calculate the value of goodwill on the basis of three year's purchase of the weighted average profits of the last five years. Profits to be weighted 1, 2, 3, 4 and 5, the greatest weightage to be given to last year. Profits of the last five years were :

Year ended		(₹)	
31st March, 2019	Profit	80,000	
31st March, 2020	Profit	1,05,000	(after considering abnormal loss of ₹41,500)
31st March, 2021	Loss	20,000	(after considering abnormal gain of ₹40,000)
31st March, 2022	Profit	1,80,000	
31st March, 2023	Profit	2,00,000	

Books of Accounts of the firm revealed that:

(i) Closing Stock as on 31st March, 2019 was overvalued by ₹40,000.

(ii) Repairs to Machinery ₹60,000 were wrongly debited to Machinery Account on 1st July, 2021. Depreciation was charged on Machinery @ 20% p.a. on diminishing balance method.

[Ans. Value of Goodwill ₹3,60,000.]

END OF CONCEPT-3

concept no.

4 Super Profit Method