

Goodwill: Nature and Valuation Module-III



Topics to be covered in this chapter

- Weighted Average Profit Method
- Calculation of Normal Business Profit
- Selection of the weight
- Calculation of Weighted Average Normal Profit
- Find Value of Goodwill
- Reason or Justification for using Weighted Average Profit



Weighted Average Profit Method

- It is a method under which weight is assigned to each year. Normal business profit of each year is multiplied with the assigned weight to determine the value, i.e., Weighted Profit. Weighted Profit as well as the weights are totalled. Total of Weighted Profit is divided by the total of weights to determine Weighted Average Profit. More weightage is assigned to the profit of recent year as it indicates the most likely profits in future.

Calculation of Normal Business Profit

It is calculated for each year as follows:

Profit (Loss) of past Year (Before Adjustment) (Given):

Add:

- i) Abnormal Losses (e.g. Loss by fire, Loss by theft, etc)
- ii) Loss on sale of Fixed Assets (Since it is not business activity)
- iii) Overvaluation of Opening Stock or Undervaluation of Closing Stock
- iv) Non-recurring expenses (Such expenses are not expected in future)
- v) Capital Expenditure charged as Revenue Expenditure
(e.g. Purchase of Machinery wrongly debited to purchase Account)

Less :

- i) Abnormal Gain (e.g. Gain (Profit) on Sale of Fixed Assets)
- ii) Overvaluation of Closing Stock or Undervaluation of Opening Stock
- iii) Non-recurring Income (Such income are not expected in future)
- iv) Income from Non-trade Investment (As it is not related to normal business activity)
- v) Partners' Remunerations, if it is not deducted
- vi) Any Future expenses, like Insurance premium

Profit (Loss) of past Year (After Adjustment) (Will get which termed as Normal Profit):

Selection of Weight

- Select the weight to be assigned (Given) to each year's profit

Weight of each year to be assigned will be provided in question itself

Calculation of Weighted Average Normal Profit

1. Profit for each year (determined as per Slide4) is multiplied by the weight assigned for that year and find the product (Weighted Profit)
2. Total the Weighted Profit (Product) and also the weights.
3. Divide the Total of Weighted profit (product) with the total of weights.

Formula

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

Find the Value of Goodwill

- Multiply Weighted Average Profit (as determined in Slide 6) by the 'Number of Years 'Purchase'. It is the value of goodwill. Express as a formula, it is

$$\text{Goodwill} = \text{Weighted Average Profit} \times \text{Numbers of Years' Purchase.}$$

Reason or Justification for using Weighted Average Profit

- Weighted Average Profit Method is considered better as compared to simple Average Profit Method as it gives more weightage to the profits of recent year This method is particularly effective when profits show rising (upward) or falling (downward) trends.

Question-1

- Profits of a firm for last five years were:

Year Ended	31 st March 2016	31 st March 2017	31 st March 2018	31 st March 2019	31 st March 2020
Profits in ₹	40,000	48,000	60,000	50,000	36,000

Calculate value of Goodwill on the basis of three years purchase of the weighted average profit after assigning weights 1,2,3,4 and 5 respectively to the profits for years ended 31st March, 2016,2017,2018,2019 and 2020.

Solution Question-1

- Solution:

Year Ended (A)	Profit in ₹ (B)	Weight (C)	Weighted Profit (D=B x C)
31 st March, 2016	40,000	1	40,000
31 st March, 2017	48,000	2	96,000
31 st March, 2018	60,000	3	1,80,000
31 st March, 2019	50,000	4	2,00,000
31 st March, 2020	36,000	5	1,80,000
Total		15	6,96,000

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

$$= \frac{6,96,000}{15} = 46,400$$

Goodwill = Weighted Average Profit x Numbers of Years' Purchase.

$$= 46,400 \times 3 = \mathbf{₹1,39,200}$$

Question-2



- Ramesh and Suresh are partners sharing profits equally. They admitted Naresh into Partnership. It was agreed to value at three years purchase following Weighted Average Profit Method on the basis of past five years profits. Weights assigned to each year would be years ended 31st March, 2015 - 1, 2016 - 2, 2017 - 3, 2018 - 4 and 2019 - 5

Year Ended	31 st March 2015	31 st March 2016	31 st March 2017	31 st March 2018	31 st March 2019
Profits in ₹	90,000	80,000	1,25,000	1,50,000	1,75,000

Scrutiny of books of account revealed the following:

- There was an abnormal loss of ₹15,000 during the year ended 31st March, 2015
- There was an abnormal gain of ₹10,000 during the year ended 31st March, 2017
- Closing stock as on 31st March, 2018 was overvalued by ₹15,000.

Calculate the value of Goodwill.

Solution Question-2

- Solution:

Year Ended (A)	Profit in ₹	Adjustment	Normal Profit in ₹
31 st March,2015	90000	15000	1,05,000
31 st March,2016	80,000	--	80,000
31 st March,2017	1,25,000	(10,000)	1,15,000
31 st March,2018	1,50,000	(15000)*	1,35,000
31 st March,2019	1,75,000	15000*	1,90,000

- Closing stock being overvalued on 31st March,2018 means that profit for the year ended 31st March,2018 is shown at higher amount. It has effect on the profit for the next year i.e. Profit for the year ended 31st March,2019 is shown at lower amount as Closing Stock of previous year is carried forward as opening Stock of next year.

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Slide 13

- Solution:

Year Ended (A)	Profit in ₹ (B)	Weight (C)	Weighted Profit (D=B x C)
31 st March,2015	1,05,000	1	1,05,000
31 st March,2016	80,000	2	1,60,000
31 st March,2017	1,15,000	3	3,45,000
31 st March,2018	1,35,000	4	5,40,000
31 st March,2019	1,90,000	5	9,50,000
Total		15	21,00,000

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

$$= \frac{21,00,000}{15} = 1,40,000$$

Goodwill = Weighted Average Profit x Numbers of Years' Purchase.

$$= 1,40,000 \times 3 = \text{₹}4,20,000$$

Question for Practice

1. Calculate the goodwill of a firm on the basis of three years' purchase of the Weighted Average Profit of the last four years. The profits of the last four financial years ended 31st March, were: 2017 – ₹ 25,000; 2018 – ₹ 27,000; 2019 – ₹ 46,900 and 2020 – ₹ 53,810. The weights assigned to each year are 2017 – 1; 2018 – 2; 2019 – 3; 2020 – 4. You are supplied the following information:
 - (i) On 1st April, 2017, a major plant repair was undertaken for ₹ 10,000 which was charged to revenue. The said sum is to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% on Reducing Balance Method.
 - (ii) The Closing Stock for the years ended 31st March, 2018 and 2019 were overvalued by ₹ 1,000 and ₹ 2,000 respectively.
 - (iii) To cover management costs an annual charge of ₹ 5,000 should be made for the purpose of goodwill valuation.



1. Total Weighted Profit = 4,00,000

Goodwill = ₹1,20,000

