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Reconstitution of a Partnership Firm –Admission of a Partner

Average Profits Method

Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that a new business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years. The goodwill, therefore, should be calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue. For example, if the past average profits of a business works out at Rs. 20,000 and it is expected that such profits are likely to continue for another three years, the value of goodwill will be Rs. 60,000 (Rs. 20,000 × 3),

Illustration 9

The profit for the last five years of a firm were as follows – year 2002 Rs. 4,00,000; year 2003 Rs. 3,98,000; year 2004 Rs. 4,50,000; year 2005 Rs. 4,45,000 and year 2006 Rs. 5,00,000. Calculate goodwill of the firm on the basis of 4 years purchase of 5 years average profits.

Solution

Year	*Profit (Rs.)*
2002	4,00,000
2003	3,98,000
2004	4,50,000
2005	4,45,000
2006	5,00,000
Total	**21,93,000**

Average Profit $= \frac{\text{Total Profit of Last 5 Years}}{\text{No.of years}} = \text{Rs. } \frac{21,93,000}{5} = \text{Rs. } 4,38,600$

Goodwill = Average Profits × No. of years purchased

= Rs. 4,38,600 × 4 = Rs. 17,54,400

The above calculation of goodwill is based on the assumption that no change in the overall situation of profits is expected in the future. The above illustration is based on simple average. Sometimes, if there exists an increasing on decreasing trend, it is considered to be better to give a higher weightage to the profits to the recent years than those of the earlier years. Hence, it is a advisable to work out weighted average based on specified weights like 1, 2, 3, 4 for respective year's profit. However, weighted average should be used only if specified. (See illustrations 10 and 11).

Illustration 10

The Profits of firm for the last five years were as follows:

Year	*Profit (Rs.)*
2002-03	20,000
2003-04	24,000
2004-05	30,000
2005-06	25,000
2006-07	18,000

Calculate the value of goodwill on the basis of three years' purchase of weighted average profits based on weights 1,2,3,4 and 5 respectively to the profits for 2002,2003,2004,2005 and 2006.

Solution

Year Ended 31st March	*Profit (Rs.)*	*Weight*	*Product*
2002-03	20,000	1	20,000
2003-04	24,000	2	48,000
2004-05	30,000	3	90,000
2005-06	25,000	4	1,00,000
2006-07	18,000	5	90,000
		15	3,48,000

$$\text{Weighted Average Profit} = \text{Rs. } \frac{3,48,000}{15} = \text{Rs. } 23,200$$

$$\text{Goodwill} = \text{Rs. } 23,200 \times 3 = \text{Rs. } 69,600$$