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Unit 3 VALUATION OF SHARES

B.com CC408 Semester 4

CORPORATE ACCOUNTING

Learning Objective:

1) Understand the Concept of Valuation of shares
2) Need and purpose of Valuation
3) Different types of value of shares
4) Factors effecting Valuation of shares
5) Know the methods to calculate value of share

Meaning and Concept of valuation of shares

In the cases of shares quoted in the recognised Stock Exchanges, the prices quoted in the Stock Exchanges are generally taken as the basis of valuation of those shares. However, the Stock Exchange prices are determined generally on the demand-supply position of the shares and on business cycle.

The quotations what result definitely don't represent valuation of a company by reference to its assets and its earning potential. Therefore, the accountants are called upon to value the shares by following the other methods.

Factors affecting of value of shares

The value of share of a company depends on so many factors such as:

1. Nature of business.

2. Economic policies of the Government.

3. Demand and supply of shares.

4. Rate of dividend paid.

5. Yield of other related shares in the Stock Exchange, etc.

6. Net worth of the company.

7. Earning capacity.

8. Quoted price of the shares in the stock market.

9. Profits made over a number of years.

10. Dividend paid on the shares over a number of years.

11. Prospects of growth, enhanced earning per share, etc.

Need and Purpose of valuation of shares

The need for valuation of shares may be felt by any company in the following circumstances:

1. For assessment of Wealth Tax, Estate Duty, Gift Tax, etc.

2. Amalgamations, absorptions, etc.

3. For converting one class of shares to another class. Example -Convertible Preference shares and Debentures

4. Advancing loans on the security of shares.

5. Compensating the shareholders on acquisition of shares by the Government under a scheme of nationalisation.

6. Acquisition of interest of dissenting shareholder under the reconstruction scheme, etc.

7. Under the scheme of nationalisation of private sectors, when it is taken over by the Government.

8. To declare NAV (Net Annual Value) by the mutual funds or finance companies.

Different types of value of shares

1) **Face value –** A company may divide its share capital into shares of Rs.10 or 100.

$$\text{Face value of share} = \frac{\text{Share capital}}{\text{Total No. of Shares}}$$

2) **Book Value –** The value calculated based upon the book values of the company.

$$\text{Book value of share} = \frac{\text{Book Value of Company}}{\text{Total No. of Shares}}$$

Note : Book Value of Company = Share Capital + Reserves +Accumulated Profits - Accumulated Losses

3) **Intrinsic value –** It is the inherent, basic value of share calculated by the net assets method.

$$\text{Intrinsic value of share} = \frac{\text{Net Assets of Company}}{\text{Total No. of Shares}}$$

4) **Fair value –** It is the average of value of share calculated by Net assets Method and Yield value Method.

$$\textbf{Fair value of share} = \frac{\textbf{Value of share by (Net asset method + Yield Method)}}{2}$$

METHODS OF VALUATION OF SHARES

1. Net Asset Method:

This is also known as Balance Sheet Method or Intrinsic Method or Break-up Value Method or Valuation of Equity basis or Asset Backing Method. Here the emphasis is on the safety of investment as the investors always need safety for their investments. Under this method, net assets of the company are divided by the number of shares to arrive at the net asset value of each share.

Under this method, the net assets of the company including goodwill and non-trading assets are divided by the number of shares issued to arrive at the value of each share. If the market value of the assets is available, the same is to be considered and in the absence of such information, the book values of the assets shall be taken as the market value. While arriving at the net assets, the fictitious assets such as preliminary expenses, the debit balance in the Profit and Loss A/c should not be considered. The liabilities payable to the third parties and to the preference shareholders is to be deducted from the total asset to arrive at the net assets. The funds relating to equity shareholders such as General Reserve, Profit and Loss Account, Balance of Debenture Redemption Fund, Dividend Equalisation Reserve, Contingency Reserve etc should not be deducted.

The following points may be borne in mind:

(1) The value of goodwill will be ascertained.

(2) Fixed assets of the company, disclosed or undisclosed in Balance Sheet, are taken at their realisable values.

(3) Floating assets are to be taken at market value.

(4) Remember to exclude fictitious assets, such as Preliminary Expenses, Accumulated Losses etc.

(5) Provision for depreciation, bad debts provision etc. must be considered.

(6) Find out the external liabilities of the company payable to outsiders including contingent liabilities.

Calculation of Net assets of a company

Computation of Net Assets

		Rs.
Net Assets		
Fixed Assets (Market Value)		• •
Investments (Market Value)		• •
Current Assets (Market Value)		• •
Goodwill, if any (Market Value)		• •
		• •
Less:		
Current Liabilities	• •	
Debentures	• •	
Pref. Share Capital (with arrear Dividend)	• •	—
Net Assets/Funds available for Equity Shareholders		• •

$$\therefore \textit{Intrinsic Value of each share} = \frac{\textit{Funds available for equity shareholders}}{\textit{Number of equity shares}}$$

Example 1:
From the information given below and the balance sheet of Cipla Limited on 31st December 2019, find the value of shares by Intrinsic value method.

Balance Sheet of Cipla Limited

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
1000, 8% Preference Shares of Rs. 100 each fully paid	1,00,000	Buildings	70,000
4,000 Equity Shares of Rs. 100 fully paid	4,00,000	Furniture	3,000
Reserves	1,50,000	Stock (Market Value)	4,50,000
Profit and Loss account	5,10,000	Investment at cost (face value 4,00,000)	3,35,000
		Debtors	2,80,000
Creditors	48,000	Bank	60,000
		Preliminary Expenditure	10,000
Total	**12,08,000**	**Total**	**12,08,000**

Building is now worth of Rs. 3,50,000 and the Preferential shareholders are having preference as to capital and dividend.

Solution :

Particulars	**Amount (Rs.)**
Building	3,50,000
Furniture	3,000
Stock	4,50,000
Investment	3,35,000
Debtors	2,80,000
Bank	60,000
Total Assets	**14,78,000**
Less: Creditors	(48,000)
Net Assets	14,30,000
Less: Preference Share Capital	(1,00,000)
Assets Available for Equity Shareholders	**13,30,000**

Value of Equity Share = Net Assets available to Equity Shareholders / No. of Equity Shares = 13,30,000 /4000= 332.50

∴ **Intrinsic value of each equity share = 332.50.**

Yield Method:

Yield is the effective rate of return on investments which is invested by the investors. It is always expressed in terms of percentage. Since the valuation of shares is made on the basis of Yield, it is called Yield-Basis Method. Yield here means the possible return that a investor gets out of his holdings like dividend, bonus shares, right shares. If the return is more, the price of the share is also more. Under this method the valuation of shares is obtained by comparing the expected rate of return with normal rate of return.

Calculation of Expected Return:

$$\text{Expected Return} = \frac{\text{Expected Profits}}{\text{Equity Capitals}} \times 100$$

Calculation of Yield value of Share:

$$\text{Value of share} = \frac{\text{Expected Rate}}{\text{Normal Rate}} \times \text{Paid up value of share}$$

Fair Value Method:

There are some accountants who do not prefer to use Intrinsic Value or Yield Value for ascertaining the correct value of shares. They however, prescribe the Fair Value Method which is the mean of Intrinsic value and Yield Value method and the same provides a better indication about the value of shares than the other methods.

Fair Value = (Intrinsic Value + Yield Value)/2

Example 2 :

The following particulars are available in respect of Goodluck Limited:

(a) Capital 450, 6% preference shares of Rs.100 each fully paid and 4,500 equity shares of Rs. 10 each fully paid.

(b) External liabilities: Rs.7,500.

(c) Reserves and Surplus Rs.35,00

(d) The average expected profit (after taxation) earned by the company Rs. 8,500.

(e) The normal profit earned on the market value of equity shares (full paid) of the same type of companies is 9%.

(f) 10% of the profit after tax is transferred to reserves.

Calculate the intrinsic value per equity share and value per equity share according to dividend yield basis and fair value of share. Assume that out of total assets, assets worth of Rs. 350 are fictitious.

Solution :

Intrinsic Value of Shares	Rs.
6% Preference Share Capital (450 × 10)	45,000
Equity Shares (4,500 × 10)	45,000
Reserves and Surplus	3,500
External Liabilities	7,500
Total Liabilities	**1,01,000**
As Total Liabilities = Total Assets	
Total Assets	**1,01,000**
Less: Fictitious Assets	(350)
External Liabilities	(7,500)
Preference Shares	(45,000)
	52,850
Net Assets Available for Equity Shareholders =(1,01,000-52850)=	**48,150**

∴ Intrinsic Value of Share = Net Assets Available Equity Shareholders/ Number of Equity Shares = 48,150 /4,500 = **Rs.10.7**

Calculation of yield value of share

Average profit after taxation	Rs. 8,500
Transfer to General Reserves (10%)	(850)
	7,650
Less: Preference dividend (6% of 45,000)	(2,700)
Profit available to equity shareholders	**4,950**

Rate of dividend = 4,950/45,000 × 10 = 11%

$$\therefore \text{ Value of Equity Share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}} \text{ x Paid -up value of a share}$$

= 11% / 9% x10

=Rs. 12.22

Fair Value of share = 10.70+12.22 /2 =11.46

Questions for Practice :

1. Goodwill is ___________.

(a) an intangible asset (b) a fixed asset (c) realisable (d) **all of the above**

2. Goodwill is to be valued when ___________.

(a) amalgamation takes place (b) one company takes over another company

(c) a partner is admitted (d) **all of the above**

3. Capital employed at the end of the year is ` 4,20,000. Profit earned ` 40,000. Average capital employed is ___________.

(a) ` 4,20,000 (b) ` **4,00,000** (c) ` 4,40,000 (d) ` 4,60,000

4. Under net asset method, value of a share depends on ___________.

(a) **net assets available to equity shareholders**

(b) net assets available to debentures holders

(c) net assets available to preference shareholders

(d) none of the above

5. While deciding net asset value, fictitious assets ___________.

(a) should be considered

(b) **should not be considered**

(c) added to total assets

(d) none of the above

6. The company earns a net profit of ` 24,000 with a capital of ` 1,20,000. The NRR is 10%. Under capitalisation of super profit, goodwill will be ___________.

(a) ` **1,20,000** (b) ` 70,000 (c) ` 12,000 (d) ` 24,000

7. Average capital employed ` 14,00,000.

Net profit 2011 2,50,000

2012 1,00,000 (loss)

2013 4,50,000

NRR 10% Goodwill at 3 years' purchase of super profit will be ___________.

(a) **1,80,000** (b) 1,50,000 (c) 1,20,000 (d) 90,000

8. Following details are extracted from the records of a company:

` 2000 9% Preference Shares of ` 100 each 2,00,000

50,000 Equity shares of ` 10 each,

Expected Profit 2,18,000

Tax Rate 40%

Transfer to general reserve 20%

Normal rate of earning 15%

Yield value per share is ___________. (a) ` 15 (b) **` 11.55** (c) ` 16 (d) ` 17.50

(Explanation)

Expected Profit =218000

Minus Tax @ 40% =(87,200)

Profit after Tax **1,30,800**

Minus Trf to reserve @ 20 %=(26,160)

=1,04,640

Minus Preference dividend (2,00,000 x 9%)=(18000)

Net Profits for shareholders =86,640/-

Expected Return =86640 / 5,00,000 x100 =17.328 or 17.33%

Yield value =Expected return /normal return *Paid up value

=17.33% /15 % x10

=11.55

9. Fair value of a share is equal to ___________.

(a) intrinsic value only

(b) yield value only

(c) **average of intrinsic and yield value**

(d) none of the above

10. Only__________ goodwill is accounted.(Answer : **Purchased)**