

Unit-II Valuation of Shares

According to the Companies Act of 1956 share means share in the Share Capital of a company and includes stock except where a distinction between stock and shares is expressed or implied. Meigs W. B. says, "the unit of corporate ownership is a share or stock." An amount noted on each share of company, it is called face value or par value of the share. On the basis of financial performance and the demand & supply forces of the market, the market price of some of the shares is determined at stock exchanges or share markets. However, where such a situation is not possible and particularly where the shares of Pvt. Ltd., companies are not quoted on stock exchanges, it becomes necessary to value them independently.

Need for Valuation

The need for the valuation of shares of a company arises in the following circumstances:

1. For formulating the amalgamation or absorption schemes
2. For purchase or sale of controlling shares in a company.
3. For reconstruction schemes to protect rights of dissenting shareholders.
4. For estate duty, wealth tax or gift tax purpose if the property consists of shares.
5. For pledging shares as a security against loan.
6. For compensating the shareholders when the shares bought back are acquired by the bank.
7. For ascertaining the number of equity shares required to be issued to debentureholders or preference shareholders when they are converted into equity shares.

Factors affecting the value of shares

- i) Profitability: Profits expected to be earned by the company have its bearing on the value of the shares.
- ii) Yield Expected by the Investors: Yield or return expected by the investors from similar types of companies has its impact on the valuation of shares of a company where the money is actually invested.
- iii) Capital Employed: The amount of capital employed to earn the expected profits also affects the valuation of shares.
- iv) Other Factors: Political, economic and social conditions prevailing within and outside the country, government policies or special situation in the stock market also speak upon the value of shares.

Method of Valuation of Shares

There are four methods of valuation of shares

- (I) Net Assets Method or Intrinsic Value Method, or Assets Backing Method.
- (II) Yield Method or Market Value Method (III) Earning Capacity Valuation Method
- (IV) Fair Value Method (V) Other Methods

Valuation of Shares

(1) Net Asset Method or Intrinsic Value Method

According to this method the value of each equity share is ascertained by using following formula.

$$\text{Intrinsic Value of each share} = \frac{\text{Net Assets} - \text{Preference Shares Capital}}{\text{Number of Equity Shares}}$$

Where, Net Assets = Market Value of all the assets including goodwill & non-trading assets **Less** Liabilities of the company. (but excluding fictitious assets & losses accumulated in Balance Sheet)

This method is also called as "Assets Backing" method.

Difficulties in finding Intrinsic or Break-up Value and how to overcome them.

1. Amount payable to preference shares : If the share capital of a company consists of preference share capital the valuation of equity shares is done in following manner. (a) When Preference Shares have priority as to capital and dividend in the event of liquidation, then deduct the preference share capital and arrears of dividend from net assets. (b) When preference shareholders have priority as to capital only, then deduct only the preference capital from net assets.
2. Uncalled Capital: If at the time of valuation there is uncalled capital, then the uncalled share capital is to be added with the net assets in order to ascertain the value of fully paid up shares.
3. Calls in arrears: The valuation of shares for shareholders who have calls in arrears will be done as a percentage on their paid up value with the nominal values of shares.
4. Equity shares with varying face values: If the company has equity shares of varying face values (e.g. some Equity Shares of Rs.10 face value and some of Rs. 5 face value), the net assets left after deducting preference capital is first apportioned to different categories of equity shares in proportion to paid up value of such categories. The amount thus arrived at would be divided by the number of shares of each of such categories to get the value of each such category
5. Since Net Assets is the difference between assets and liabilities, it represents the amount of "Shares Capital + Reserves + Surplus". However the reserves and surplus are subject to adjustment of miscellaneous expenses and losses.

Illustration: I (Intrinsic Value - Simple problem)

From the Balance Sheet of Sukharam Ltd., and the additional information given below ascertain the intrinsic value of each share.

Liabilities	Rs.	Assets	Rs.
Share Capital	300000	Fixed Assets:	
Equity share of Rs. 10 each			
12% Preference share of Rs.10 each	100000	Goodwill	120000
Reserves & Surplus		Leasehold property	350000
General Reserve	80000	Fixtures	60000
Profit & Loss A/c	70000	Investments	50000
		Current Assets	75000
Unsecured Loans	100000	Loans & Advances	15000
Current Liabilities	30000	Miscellaneous Expenditure	10000
Total	680000	Total	680000

Additional Information :-

- 1) Leasehold property and Fixtures are valued at Rs.400000 and Rs.50000 respectively.
- 2) Goodwill should be valued at three years purchase of average profit of last five years. The profit for the last five years are Rs.70000 Rs.90000 Rs.75000 Rs.85000 and Rs.80000