

# 2<sup>nd</sup> Webinar on Paper 17

**Subject: Corporate Financial Reporting**

**Topic: Valuation of Shares & Goodwill**

**Exam Oriented Webinar for CMA Final Students**



Afternoon Session ♦ 5<sup>th</sup> MAY 2020 ♦ 04:00 PM to 05:00 PM ♦ [www.3spro.blogspot.com](http://www.3spro.blogspot.com)

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# **VALUATION OF SHARES**

## **METHODS OF SHARE VALUATION**

**There are three basic methods of valuing shares. They are as follows :**

- **1. Asset-backing or Intrinsic Value Method.**
- **2. Yield-basis or Earning Capacity Method.**
- **3. Fair Value Method or Dual Method.**

## Asset-Backing or Intrinsic Value Method

- **Intrinsic Value of each Share = Funds Available for Equity Shareholder's / Number of Equity Shares**
- **Net Assets = Share Capital + Reserves and Surplus on Revaluation – Loss on Revaluation**

| Computation of Net Assets                          |     |             |
|----------------------------------------------------|-----|-------------|
| Particulars                                        | ₹   | ₹           |
| Net Assets                                         |     |             |
| Fixed Assets (Market Value)                        |     | XXX         |
| Investments (Market Value)                         |     | XXX         |
| Current Assets (Market Value)                      |     | XXX         |
| Goodwill if any (Market Value)                     |     | XXX         |
|                                                    |     | XXXX        |
| Less:                                              |     |             |
| Current Liabilities                                | XXX |             |
| Debentures                                         | XXX |             |
| Preference Share Capital (with arrear dividend)    | XXX | <u>XXXX</u> |
| Net Assets/Funds Available for Equity Shareholders |     | XXXX        |
|                                                    |     | XXXX        |

# **Yield Basis (Profit Basis or Dividend Basis)**

## **Profit Basis**

- Capitalised Value of Profit = Profit / Normal rate of Return
- Value of each Equity Share = Capitalised Value of Profit / Number of Shares
- Value of an Equity Share = [Actual yield / Expected yield] × Paid up value of a share

## **Dividend Basis**

- Capitalised Value of Profit = Dividend / Normal Rate of Return
- Value of each Equity Share = Capitalised Value of Profit / Number of Equity Shares

**Normal Rate of Return = Yield or Expected Yield**

## Fair Value Method

- **Fair Value = [Intrinsic Value + Yield Value] / 2**

# **VALUATION OF SHARES**

- **A share is the smallest unit of ownership of a company.**
- **It happens to be one of the sources by which a company raises funds from the market.**
- **The value of a share does not remain static over its life-time.**
- **Rather it changes over the period due to various circumstances.**
- **Thus, knowing the value of share at a particular point of time is of great importance.**

# **PURPOSE OF SHARE VALUATION**

The shares of a company are required to be valued for various purposes. Some of the most important purposes include the following:

- ✓ **1. For selling shares of a shareholder to a purchaser (which are not quoted in the stock exchange)**
- ✓ **2. For acquiring a block of shares which may or may not give the holder thereof a controlling interest in the company.**
- ✓ **3. To shares by employees of the company where the retention of such shares is limited to the period of their employment.**
- ✓ **4. To formulate schemes of merger and acquisition.**

- ✓ **5. To acquire interest of dissenting shareholders under a scheme of reconstruction.**
- ✓ **6. For granting loans on the basis of security of shares**
- ✓ **7. To compensate shareholders on the acquisition of their shares by the government under a scheme of nationalization.**
- ✓ **8. For conversion of securities, say preference shares into equity shares.**
- ✓ **9. To resolve a deadlock in the management of a company on the basis of the controlling block of shares given to either of the parties.**

# **FACTORS AFFECTING VALUATION OF SHARES**

The different factors that affect the valuation of shares are:

- ✓ **1. Nature of the industry to which the company belongs**
- ✓ **2. The companies past performance**
- ✓ **3. Economic conditions of the country**
- ✓ **4. Other political and economic factors (e.g., possibility of nationalization, excise duty on goods produced, etc.)**
- ✓ **5. Demand and supply of shares**
- ✓ **6. Income yielding capacity of the company**
- ✓ **7. The availability of sufficient assets over liabilities**
- ✓ **8. Proportion of liabilities and capital**
- ✓ **9. Rate of proposed dividend and past profit of the company**
- ✓ **10. Yield of other related shares of the Stock Exchange.**

# VALUATION OF SHARES

## **A. Asset-Backing Method:**

Since the valuation is made on the basis of the assets of the company, it is known as Asset-Basis or Asset-Backing Method. At the same time, the shares are valued on the basis of real internal value of the assets of the company and that is why the method is also termed Intrinsic Value Method or Real Value Basis Method. This method may be made either:

- (i) On a going concern basis; or
- (ii) On Break-up value basis.

# VALUATION OF SHARES

## **B. Yield-Basis 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. Under Yield-Basis method, valuation of shares is made on either of the following basis:

(i) Profit Basis; or (ii) Dividend Basis.

(i) Under Profit Basis: Under this method, at first, profit should be ascertained on the basis of past average profit; thereafter, capitalized value of profit is to be determined on the basis of normal rate of return, and, the same (capitalized value of profit) is divided by the number of shares in order to find out the value of each share.

# VALUATION OF SHARES

## **B. Yield-Basis Method:**

(ii) Under Dividend Basis: Valuation of shares may be made either (a) on the basis of total amount of dividend, or (b) on the basis of percentage or rate of dividend:

(a) on the basis of Total Value of Dividend

(b) On the basis of percentage or Rate of Dividend

## **C. Fair Value Method:**

There are some valuers who do not accept either the Intrinsic Value or the Yield Value for ascertaining the value of shares. They prescribe the Fair Value Method which happens to be the arithmetic mean of Intrinsic Value Method and Yield Value Method. The same provides a better indication about the value of shares than the earlier two methods.

# VALUATION OF GOODWILL

- Goodwill is an intangible fixed asset of an organisation which has to be reflected in its books of accounts on certain circumstances.
- For this purpose, a money value is required to be attached to this intangible asset.
- The process of estimating the value of goodwill using certain accepted methodologies is referred to as valuation of goodwill.

# **METHODS OF GOODWILL VALUATION**

## **Average Profit Method:**

- As per this method, the value of goodwill depends on the past profit earning capacity of the entity.
- The past profits of certain given number of years are used to determine 'Average Profit'. Such Average Profit may be either 'Simple Average Profit' or 'Weighted Average Profit'.
- Finally, the value of goodwill is determined by multiplying the Average Profit so calculated by certain 'Number of Years' Purchase'.

Value of Goodwill = Average Profit × No. of Years' Purchase

## **Profit:**

- The term 'profit', here, refers to the past profits earned by the firm.
- These past profits are required to be adjusted/ modified for any abnormal or non-recurring items (whether gain or loss), which are not expected to arise in the future under normal circumstances.
- The past profit figures are, thus to be used to determine the 'Future Maintainable Profits' that is expected to be earned by the entity.

## Simple Average Profit:

When there is no definite trend in the past profits, the past profits are simply aggregated and then divided by the number of years to determine the Average Profit. Since, in this case no weights are used on the past profits, the Average Profit, so determined, is referred to as Simple Average Profit.

$$\therefore \text{Simple Average Profit} = \frac{P_1 + P_2 + \dots + P_n}{n} \text{ where, } P = \text{Profit of respective year;} \\ n = \text{Number of years}$$

## Weighted Average Profit:

When there exists a clear trend (either increasing or decreasing) in the past profits, the past profits are firstly by multiplied by certain 'weights', and then the products are aggregated. Finally, the aggregate figure is divided by the 'aggregate of all the weights' to arrive at the Weighted Average Profit.

$$\therefore \text{Weighted Average Profit} = \frac{P_1.W_1 + P_2.W_2 + \dots + P_n.W_n}{W_1 + W_2 + \dots + W_n} \quad \text{where, } P = \text{Profit of respective year;}$$

$W$  = Weight of respective year;

$n$  = Number of years

# VALUATION OF GOODWILL

## **Number of Years' Purchase:**

For valuation of goodwill, the average profit determined is usually multiplied by a figure referred to as "Number of Years' Purchase". The phrase 'Number of Years' Purchase' refers to the expected number of future years for which the firm is expected to earn the average profit from the year of purchase. In other words, it is assumed to be the time period during which the entity will enjoy the profit earning capacity.

# VALUATION OF GOODWILL

## Capitalisation Method:

There are two ways of determining the value of goodwill using the capitalisation approach. They are:

**Capitalisation of Average Profits:** When the average profits are capitalised, then firstly, the 'Capitalised Value of the firm' is determined and there from the 'Net Assets' are deducted to arrive at value of goodwill.

Mathematically, Capitalised Value of the firm =  $\frac{\text{Average Future maintainable profit}}{\text{Normal rate of return (\%)}}$ ; and

**Capitalisation of Super Profits:** When the super profits are capitalised, then the value of goodwill is directly ascertained.

$$\text{Value of Goodwill} = \frac{\text{Super Profit}}{\text{Normal rate of return (\%)}}$$

### Annuity Method:

- This method of goodwill valuation considers the 'time value of money'.
- Under this method, Value of Goodwill = Super Profit × Annuity Value

#### Student Note:

The different variables which influence the valuation of goodwill under 'Super Profit method' are:

- **Super Profit:** It refers to the excess profit earned by the entity over the normal profit that should be earned by a similar firm in the industry.
- **Annuity:** Annuity refers to a series of continuous cash flows (either cash inflows or cash outflows) of equal amount that occur in every period, over a specified period of time.
- **Annuity Value:** It is determined either from the Annuity Table or may be ascertained from the following formula:

$$\text{Annuity Value} = \frac{(1+r)^n - 1}{r(1+r)^n} \text{ where, } r = \text{Rate of Interest per period, and } n = \text{Number of periods.}$$

### Student Note:

The different variables which influence the valuation of goodwill under 'Super Profit method' are:

- **Super Profit:** Every firm in an industry is expected to earn a normal rate of return. If a particular firm of the industry manages to earn a rate of return that happens to be more than the normal industry rate of return, then such a firm is said to be earning 'Super Profits'. The value of goodwill, under this method, is correlated with this extra profit earning capacity of the firm.
- **Average Future Maintainable Profit:** It refers to the profit that is expected to be earned by the entity in the future under normal circumstances. For this purpose, the past profits that are required to be adjusted/ modified for any abnormal or non-recurring items (whether gain or loss).
- **Capital Employed:** Capital Employed refers to the amount of capital that has been invested in the firm. It is measured as the excess of current value of Total Assets (excluding Goodwill and Fictitious assets) over the current liabilities. Alternatively, it is the aggregate of Owned Capital, Accumulated Profits and Borrowed Capital, if any.
- **Average Capital Employed:** Average Capital Employed is determined by averaging the capital employed at the beginning of the accounting period and that at the end of the accounting period. Mathematically,

$$\text{Average Capital Employed} = \frac{\text{Opening Capital Employed} + \text{Closing Capital Employed}}{2}$$

- **Normal Rate of Return:** It is the rate of return that is usually earned by any firm belonging to a particular industry.
- **Number of Years' Purchase:** For valuation of goodwill, the super profit is usually multiplied by a figure referred to as "Number of Years' Purchase". The phrase 'Number of Years' Purchase' refers to the expected number of future years for which the firm is expected to earn such super profits from the year of purchase.

(b) From the following information, calculate the Fair Value of an Equity Share:

- (i) 400000 Equity Shares of ₹ 10 each (paid up ₹ 8 each).
- (ii) 700000 Equity Shares of ₹ 5 each fully called up (Call-in arrears @ ₹ 2 on 200000 shares).
- (iii) 10000, 9% Preference Shares of ₹ 100 each fully paid up.
- (iv) Reserves and Surplus ₹ 73,76,000.
- (v) Tangible Fixed Assets ₹ 3,00,000. 50% of total Tangible Fixed Assets are found undervalued by 50% of market value and 50% of remaining are found overvalued by 50% of market value. 10% Investments: [Face value ₹ 80,000] ₹ 1,00,000. Of the Investments 10% is trade and the balance non-trade. All trade Investments are to be valued at 10% below cost.
- (vi) External Liabilities ₹ 10,00,000.
- (vii) Expected Future Maintainable Profits before tax ₹ 25,59,000.
- (viii) Rate of Tax-30% (Ignore Corporate Dividend Tax).
- (ix) Normal Rate of Earnings – 9%.

6. (a) The summarised Balance Sheet of TMI Ltd. for the year ended on 31st March, 2017, 2018 and 2019 are as follows:

|                                                | ₹ in thousand |              |              |
|------------------------------------------------|---------------|--------------|--------------|
|                                                | 2017          | 2018         | 2019         |
| 1,60,000 equity shares of ₹ 10 each fully paid | 1,600         | 1,600        | 1,600        |
| General Reserve                                | 1,200         | 1,400        | 1,600        |
| Profit and Loss Account                        | 140           | 160          | 240          |
| Trade Payable                                  | 600           | 800          | 1,000        |
|                                                | <u>3,540</u>  | <u>3,960</u> | <u>4,440</u> |
| <b>Assets:</b>                                 |               |              |              |
| Goodwill                                       | 1,000         | 800          | 600          |
| Building and machinery less depreciation       | 1,400         | 1,600        | 1,600        |
| Inventory                                      | 1,000         | 1,200        | 1,400        |
| Trade Receivable                               | 20            | 160          | 440          |
| Bank balance                                   | 120           | 200          | 400          |
|                                                | <u>3,540</u>  | <u>3,960</u> | <u>4,440</u> |

|                                                                                                                                       | 2017  | 2018  | 2019  |
|---------------------------------------------------------------------------------------------------------------------------------------|-------|-------|-------|
| <b>Building and machinery less depreciation</b>                                                                                       | 1,800 | 2,000 | 2,200 |
| <b>Inventory</b>                                                                                                                      | 1,200 | 1,400 | 1,600 |
| <b>Net profit (including opening balance after writing off depreciation, goodwill, tax provision and transfer to general reserve)</b> | 420   | 620   | 820   |

(ii) Capital employed in the business at market value at the beginning of 2016-2017 was ₹ 3,66,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by T Ltd. is 12.5%.

(iii) The balance in the general reserve on 1st April, 2016 was ₹ 10 lakhs.

(iv) The goodwill shown on 31st March, 2017 was purchased on 1st April, 2016 for ₹ 10 lakhs on which date the balance in the Profit and Loss Account was ₹ 1,20,000.

You are required to find out the average capital employed in each year. Also compute goodwill to be valued at 5 years purchase of Super Profit (Simple average method). 8

**Please Turn Over**



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