

**Semester – V**  
**Corporate Accounting – I**  
**Valuation of Goodwill and Shares**  
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**PART – B**

**Valuation of Shares:**

A share represents an interest in a company. There are a number of ways in which the shares of a company may be valued. It can be either as an entitlement to a share of future profits, or as an interest in the net assets that comprise the company. Therefore, the choice of method of valuation is often governed by the reasons for the investment. The majority of shareholders of a company are interested in dividends. On the other hand, a majority of shareholders may be interested in the realisable value of the company's net assets since they can liquidate a company.

**Need for Valuation:**

1. When one company acquires majority of the shares of another company, it is necessary to value such shares.
2. When two or more companies amalgamate or one company absorbs another company, it is necessary to form a fair and equitable basis of valuation for transferring the shares. The prices quoted in the stock exchange, if any, do not properly indicate the actual value of the shares. For formulating amalgamation and absorption schemes, a fresh valuation method should be taken up.
3. When a company has decided to undergo a process of reconstruction, to protect the rights of the dissenting shareholders, a fresh valuation of shares should be taken up. The dissenting shareholders should be paid as per the valuation of shares in respect of their holdings.
4. When preference shares or debentures are converted into equity shares, a fresh valuation method should be adopted for equity shares to calculate exchange ratio. It is necessary to ascertain the number of equity shares required to be issued for debentures as preference shares.
5. When a partnership firm is dissolved and the firm is having some investment in shares, it is necessary to value those shares for proper distribution among the partners.

**Factors Affecting Valuation of Shares:**

1. The nature of the company's business.
2. Percentage of dividend declared on the shares.
3. The income yielding capacity of the company.
4. The availability of sufficient assets over liabilities.
5. Financial, political and other factors affecting the business.

**Methods of Valuation:**

There are three widely applied methods for the valuation of shares:

- a) The Assets Backing Method; and  
 b) The Yield Valuation Method.

**1. Assets Backing Method**

a) Without separate valuation of goodwill	
Total sundry assets	
[Including goodwill and non-trading assets like investments but	
Excluding fictitious assets like miscellaneous expenditure or	
Profit & loss account (dr.)]	x
Less: Liabilities	
- External liabilities / Current Liabilities	
- Contingent or prospective liabilities	
(Like outstanding debenture interest,	
Damage payable etc.)	x
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Net Worth / Net Assets	x
Less: Preference Shareholders claim (Preference share capital,	
Premium payable on redemption, arrear preference dividend)	x
	-----
	x
Add: Notional calls on partly paid shares	x
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Net assets backing equity shares or Net assets available for equity	x
Shareholders	-----
$\text{Intrinsic value of each fully paid shares} = \frac{\text{Net Assets available for Equity Shareholders/}}{\text{No. of equity shares}}$	
$\text{Intrinsic value of each partly paid shares} = \text{Intrinsic value of each fully paid shares} - \text{Notional call per shares.}$	
b) With separate valuation goodwill	
Step 1. Calculate Trading Capital employed (as said under valuation of goodwill	
under super profit methods)	
Step 2. Calculate goodwill as said before	
Step 3. Trading Capital Employed	x
Add: Value of goodwill computed	x
Add: Non Trading Assets	x
Less: Preference Shareholders claim	x
Add: Notional call on partly paid shares	x
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	X
Less: Goodwill at cost	x
Less: Proposed Dividends	x

Net Assets including Goodwill available for equity shareholders	x
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Intrinsic value of each fully paid equity shares = NAFESH / No. of equity shares.

NAFESH = Net assets available for equity shareholders.

Intrinsic value of each partly paid equity shares = Intrinsic value of each fully paid equity shares – Notional call per shares.

**2. Yield method:**

a) On the basis of rate of return

Average annual profits after tax	x
Less: Transfer to reserve (if not mentioned in The given questions U/s 205A, 10% of Net Profits)	x
Less: Preference shareholders dividend	x
Profits available for equity shareholders	x

Expected rate of return =  $\frac{\text{Profits available for equity shareholders}}{\text{Paid up value of equity share capital} \times 100}$

Yield / Market value per shares =  $\frac{\text{Expected rate of return}}{\text{Normal Rate of return} \times \text{paid up value of each shares}}$

b) On the basis of capitalisation of profits

Value per shares =  $\frac{\text{Capital value of profits for equity shareholders}}{\text{Number of equity shares}}$

Market value of Rs.1 =  $\frac{\text{Capital value of profits available for ESH}}{\text{Paid up equity capital}}$

Market value per share = Value per Rs.1 x Paid up value of each shares.

**3. Fair Value Method:**

Value per shares = Intrinsic value per shares + Yield value per shares

**Practical problems & Solutions:**

1. The following particulars are available in relation to A Ltd. :
  - a) Equity share capital 5000 equity shares of ₹20 each.
  - b) Preference share capital 1000, 8% preference shares of ₹100 each.
  - c) Reserves ₹30000.
  - d) Current liabilities ₹18000.
  - e) Loss on revaluation of fixed assets ₹12000.
  - f) Average trading profits ₹30000 (after tax).
  - g) Normal rate of return on capital employed 10%.
  - h) Goodwill should be valued at 3 years' purchase of super profit.

Calculate intrinsic value per equity share.

**Solution:**

1. Calculating of capital employed:

Equity shares capital	₹100000
8% Preference share capital	₹100000
Reserves	₹30000
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	₹230000
Less: Loss on Revaluation	₹12000
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Capital Employed	₹218000
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2. Calculation of super profit:

Average trading profit after tax	₹30000
Less: Normal Return (10% of capital employed)	₹21800
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Super Profit	₹8200
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3. Value of goodwill = 3 years' purchase of super profit  
= 3 x Rs.8200 = Rs.24600

4. Valuation of shares under Intrinsic value method

Capital Employed (as in 1. Above)	₹218000
Less: Preference Shareholder's Claim	₹100000
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	₹118000
Add: Goodwill (as valued in 3. Above)	₹24600
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	₹142600
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Number of Shares	5000
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Value per Share (Rs.142600/5000)	₹28.52
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2. The following particulars are available in relation to Hari Pvt. Ltd. Co.

- Capital : 6000, 6% Preference shares of ₹100 each fully paid and 5000 equity shares of ₹100 each fully paid.
  - External liabilities ₹.75000.
  - Reserve and surplus ₹50000.
  - The average expected profit (after tax) ₹90000.
  - The normal profit earned on the market value of equity shares of the same type of company – 10%.
  - Transfer of Reserve 10% of the Net Profit.
- Calculate value per equity share according to Dividend Yield Basis.

**Solution:**

## Calculation of Expected Rate of Dividend

Average expected profit after tax	₹90000
Less: Transferred to General Reserve (10%)	₹9000
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	₹81000
Less: Preference dividend @ 6% on Rs.600000	₹36000
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Profits available for equity shareholders	₹45000
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$$\begin{aligned} \text{Expected rate of dividend} &= \frac{\text{Profit available for ESH}}{\text{Total paid up equity}} \times 100 \\ &= \frac{₹45000}{₹500000} \times 100 \\ &= 9\% \end{aligned}$$

## Dividend Yield method of valuation

$$\begin{aligned} \text{Value per share} &= \frac{\text{Expected rate of return}}{\text{Normal rate of return}} \times \text{paid up value} \\ &= \frac{9\%}{10\%} \times ₹100 = ₹90. \end{aligned}$$

## 3. The capital structure of H Ltd. is as follows:

14% preference shares of ₹10 each	₹2000000
Equity shares of ₹10 each	₹3200000
Reserves & surplus	₹1600000
10% debentures	₹2400000
11% loan from banks/financial institutions	₹2800000
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	₹12000000
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The average annual profit before payment of tax and interest is ₹2400000. The income tax is assumed to be @ 40%.

Compute the value of equity shares of the company, if the applicable price-earning ratio is 9.

**Solution:**

## 1. Calculation of earnings per equity shares:

Average annual profits before interest and tax	₹2400000
Less: Interest on debentures (₹2400000 x 10%)	₹240000
Less: Interest on loan from bank (₹2800000 x 11%)	₹308000
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Profits before tax	₹1852000
Less: Income tax @ 40%	₹740800

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Profit after tax	₹1111200
Less: Transfer to Reserve @ 10%	₹111120
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	₹1000080
Less: Preference dividends (₹2000000 x 14%)	₹280000
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Profit available for equity shareholders	₹720080
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$$\begin{aligned} \text{Earnings per share} &= \text{Profit available for equity shareholders} / \text{Number of shares} \\ &= ₹720080 / 320000 \\ &= ₹2.25025 \end{aligned}$$

2. Value per shares:

$$\text{P/E Ratio} = \text{Value per shares} / \text{Earnings per share}$$

$$\text{Value per shares} = 9 \times ₹2.25025$$

$$= ₹20.25.$$

