VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

1990

ANNEXTURES: I

PROVISIONS OF INCOME TAX ACT, 1961.
ANNEXURE I

PROVISIONS OF INCOME TAX ACT, 1961

2(13) "business" includes any trade, commerce or manufacture or any adventure or concern in the nature of trade, commerce or manufacture.

2(14) "capital asset" means property of any kind held by an assessee, whether or not connected with his business or profession, but does not include -

i) any stock in trade, consumable stores or raw materials held for the purposes of his business or profession;

ii) personal effects, that is to say, moveable property (including wearing apparel and furniture, but excluding jewellery) held for personal use by the assessee or any member of his family dependent on him.

Explanation: For the purposes of this sub-clause, "jewellery" includes -

a) ornaments made of gold, silver, platinum or any other precious metal or any alloy containing one or more of such precious metals, whether or not containing any precious or semi-precious stones, and
whether or not worked or sewn into any wearing apparel;

b) precious or semi precious stones, whether or not set in any furniture, utensil or other article or worked or sewn into any wearing apparel;

iii) agricultural land in India, not being land situated-

a) in any area which is comprised within the jurisdiction of a municipality (whether known as a municipality, municipal corporation, notified area committee, town area committee, town committee or by any other name) or a cantonment board and which has a population of not less than ten thousand according to the last preceding census of which the relevant figures have been published before the first day of the previous year; or

b) in any area within such distance, not being more than eight kilometres, from the local limits of any municipality or cantonment board referred to in item (a),
as the Central Government may, having regard to the extent of and scope for urbanisation of that area and other relevant considerations, specify in this behalf by notification in the Official Gazette;

iv) 6\% percent Gold Bonds, 1977, (or 7 percent Gold Bonds, 1980) (for National Defence Gold Bonds, 1980) issued by the Central Government);

v) Special Bearer Bonds, 1991, issued by the Central Government);

2(22B) "fair market value", in relation to a capital asset, means -

i) the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and

ii) where the price referred to in sub clause (i) is not ascertainable, such price as may be determined in accordance with the rules made under this Act;

2(24) "income" includes -

i) Profits and gains;
ii) dividend;

iiA) voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes (not being contributions made with a specific direction that they shall forms part of the corpus of the trust or institution).

iii) Explanation: For the purposes of this sub clause, "trust" includes any other legal obligation;

iv) the value of any perquisite or profits in lieu of salary taxable under clauses (2) and (3) of section 17;

iv) the value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company, or by a relative of the director or such person, and any sum paid by any such company in respect of any obligation which, but for such payment
would have been payable by the director or other person aforesaid;

iva) the value of any benefit or perquisite whether convertible into money or not, obtained by any representative assessee mentioned in clause (iii) or clause (iv) of sub section (1) 160 or by any person on whose behalf or for whose benefit any income is receivable by the representative assessee (such person being hereafter in this sub clause referred to as the "beneficiary") and any sum paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary;

v) any sum chargeable to income tax under clause (ii) and (iii) of section 28 or section 41 or section 59;

va) the value of any benefit or perquisite taxable under clause (iv) or section 28;

vi) any capital gains chargeable under section 45;

vii) the profits and gains of any business of insurance carried on by a mutual insurance
company or by a co-operative society, computed in accordance with section 44 or any surplus taken to be such profits and gains by virtue of provisions contained in the First Schedule;

viii) (Omitted by the Finance Act, 1988 w.e.f. 1.4.1988. Original sub clause (viii) was inserted by the Finance Act, 1964, w.e.f. 1.4.1964).

ix) any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever;

x) any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund or any fund set up under the provisions of the employees' State Insurance Act, 1948 (34 of 1948) or any other fund for the welfare of sub employees;

2(42A) "Short term capital asset" means a capital asset held by an assessee for not more than thirty six) months immediately preceding the date of its transfer.
(Provided that in the case of a share held in a company, the provisions of this clause shall have effect as if for the words "thirty six months", the words "twelve months" had been substituted.)

Explanation : (i) in determining the period for which any capital asset is held by the assessee -

a) in the case of a share held in a company in liquidation, there shall be excluded the period subsequent to the date on which the company goes into liquidation;

b) in the case of a capital asset which becomes the property of the assessee in the circumstances mentioned in sub section (1) of section 49, there shall be included the period for which the asset was held by the previous owner referred to in the said section;

c) in the case of a capital asset being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a transfer referred to in clause (vii) of section 47, there shall be included the period for which the share or shares in the amalgamating company were held by the assessee)
ii) in respect of capital assets other than those mentioned in clause (i) the period for which any capital asset is held by the assessee shall be determined subject to any rules which the Board may make in this behalf;

2(43B) "short term capital gain" means capital gain arising from the transfer of a short term capital asset;

2(47) "transfer", in relation to a capital asset, includes -

i) the sale, exchange or relinquishment of the asset; or

ii) the extinguishment of any rights therein; or

iii) the compulsory acquisition thereof under any law; or

iv) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock in trade of a business carried on by him, such conversion or treatment; or

v) any transaction involving the allowing of the possession of any immovable property to
be taken or retained in part performance of a contract of the nature referred to in section 53A of the Transfer of Property Act, 1882 (4 of 1882); or

vi) any transaction (whether by way of becoming a member of, or acquiring shares in a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation: For the purposes of sub clauses (v) and (vi), "immovable property" shall have the same meaning as in clause (d) of section 269UA;

"Salary", "perquisite" and "profits in lieu of salary" defined.

For the purposes of sections 15 and 16 and of this section, -

1) "Salary" includes -

i) wages;
ii) any annuity or pension;

iii) any gratuity;

iv) any fees, commissions, perquisites or profits in lieu of or in addition to any salary or wages;

v) any advance of salary;

va) any payment received by an employee in respect of any period of leave not availed of by him;

vi) the annual accretion to the balance at the credit of an employee participating in a recognised provident fund, to the extent to which it is chargeable to tax under rule 6 of Part A of the Fourth Schedule; and

vii) the aggregate of all sums that are comprised in the transferred balance as referred to in sub rule (2) of rule 11 of Part A of the Fourth Schedule of an employee participating in a recognised provident fund, to the extent to which it is chargeable to tax under sub rule (4) hereof;

2) "Perquisite" includes -
i) the value of rent free accommodation provided to the assessee by his employer;

ii) the value of any concession in the matter of rent respecting any accommodation provided to the assessee by his employer;

iii) the value of any benefit or amenity granted or provided free of cost or at concessional rate in any of the following cases -

a) by a company to an employee who is a director thereof;

b) by a company to an employee being a person who has a substantial interest in the company;

c) by any employer (including a company) to an employee to whom the provision of paragraphs (a) and (b) of this sub clause do not apply and whose income under the head "Salaries" (whether due from, or paid or allowed by, one or more employers), exclusive of the value of all benefits or amenities not provided for by way of monetary payment, exceeds twenty four thousand rupees;
iv) any sum paid by the employer in respect of any obligation which, but for such payment, would have been payable by the assessee; and

v) any sum payable by the employer, whether directly or through a fund, other than a recognised provident fund or an approved superannuation fund or a Deposit linked Insurance Fund established under section 3G of the Coal Mines Provident Fund and Miscellaneous Provisions Act, 1948 (46 of 1948), or as the case may be, section 6C of the Employees' Provident Funds and Miscellaneous Provisions Act, 1952 (19 of 1952), to effect an assurance on the life of the assessee or to effect a contract for an annuity;

3) "Profits in lieu of salary" includes -

i) the amount of any compensation due to or received by an assessee from his employer or former employer at or in connection with the termination of his employment or the modification of the terms and conditions relating thereto;
ii) any payment (other than any payment referred to in clause (10) clause (10A) clause (10B) clause (11), clause (12) or clause (13A) of section (10), due to or received by an assessee from an employer or a former employer or from a provident or other fund (not being an approved superannuation fund), to the extent to which it does not consist of contributions by the assessee or interest on such contributions.

Capital Gains.

45. 1) Any profits or gains arising from the transfer of a capital asset effected in the previous year shall, as otherwise provided in sections (53, 54, 54B, 54D, 54E, 54F and 54G), be chargeable to income tax under the head "Capital Gains", and shall be deemed to be the income of the previous year in which the transfer took place.

2) Notwithstanding anything contained in sub section (1), the profits or gains arising from the transfer by way of conversion by the owner of a capital asset into, or its
treatment by him as stock in trade of a business carried on by him shall be chargeable to income tax as his income of the previous year in which such stock in trade is sold or otherwise transferred by him and, for purposes of section 48, the fair market value of the asset on the date of such conversion or treatment shall be deemed to be the full value of the consideration received or accruing as a result of the transfer of the capital asset.

3) The profits or gains arising from the transfer of a capital asset by a firm or other association of persons or body of individuals (not being a company or a co-operative society) in which he is or becomes a partner or member, by way of capital contribution or otherwise, shall be chargeable to tax as his income of the previous year in which such transfer takes place and, for the purposes of section 48, of the firm, association or body as the value of the capital asset of the consideration received or accruing as a result of the transfer of the capital asset.
4) The profits or gains arising from the transfer of a capital asset by way of distribution of capital assets shall be chargeable to tax as the income of the firm, association, or body, or individuals (not being a company or a co-operative society) of the previous year in which, for the purposes of section 48, the fair market value of the assets on the date of such transfer or accruing as a result of transfer.

5) Notwithstanding anything contained in sub-section (1), where the capital gains arise from the transfer of a capital asset, being a transfer by way of compulsory acquisition under any law, or a transfer, the consideration for which is determined or approved by the Central Government or the Reserve Bank of India, and the compensation or the consideration for such transfer is enhanced or further enhanced by any court, tribunal or other authority, the capital gain shall be dealt with in the following manner, namely :-
a) the capital gain computed with reference to the compensation awarded in the first instance or, as the case may be, the consideration determined or approved in the first instance by the Central Government or the Reserve Bank of India shall be chargeable as income under the head "Capital Gains" of the previous year in which the transfer took place; and

b) the amount by which the compensation or consideration is enhanced or further enhanced by the court, tribunal or other authority shall be deemed to be income chargeable under the head "Capital Gains" of the previous year in which such amount is received by the assessee.

Explanation: For the purposes of this sub section, -

i) in relation to the amount referred to in clause (b), the cost of acquisition and the cost of improvement shall be taken to be nil;

ii) the provisions of this sub section shall
apply also in a case where the transfer took place prior to the 1st day of April, 1988;

iii) where by reason of the death of the person who made the transfer, or for any other reason, the enhanced compensation or consideration is received by any other person, the amount referred to in clause (b) shall be deemed to be the income, chargeable to tax under the head "Capital Gains", of such other person.

Capital gains on distribution of assets by companies in liquidation.

46. 1) Notwithstanding anything contained in section 45, where the assets of a company are distributed to its shareholders on its liquidation, such distribution shall not be regarded as a transfer by the company for the purposes of section 45.

2) Where a shareholder on the liquidation of a company receives any money or other assets from the company, he shall be chargeable to
income tax under the head "Capital Gains", in respect of the money so received or the market value of the other assets on the date of distribution, as reduced by the amount assessed as divided within the meaning of sub clause (c) of clause (22) of section 2 and the sum so arrived at shall be deemed to be full value of the consideration for the purposes of section 48.

Transactions not regarded as transfer.

47. Nothing contained in section 45 shall apply to the following transfers:

iv) any transfer of a capital asset by a company to its subsidiary company, if -

a) the parent company or its nominees hold the whole of the share capital of the subsidiary company, and
b) the subsidiary company is an Indian company;

v) any transfer of a capital asset by a subsidiary company to the holding company, if -
a) the whole of the share capital of the subsidiary company is held by the holding company, and

b) the holding company is an Indian company.

Provided that nothing contained in clause (iv) or clause (v) shall apply to the transfer of a capital asset made after the 29th day of February, 1988 as stock in trade;

vi) any transfer, in a scheme of amalgamation, of a capital asset by the amalgamating company to the amalgamated company if the amalgamated company is an Indian company;

vii) any transfer by a shareholder, in a scheme of amalgamating, of a capital asset being a share or shares held by him in the amalgamation company if -

a) the transfer is made in consideration of the allotment to him of any share or shares in the amalgamated company, and
b) the amalgamated company is an Indian company;

In section 48 of the Income-tax Act, in subsection (1), to clause (i), the following proviso and the explanation there to shall be added, namely:

Provided that in the case of an assessee, who is a non-resident Indian, capital gains arising from the transfer of a capital asset being shares in or debentures of, an Indian company shall be computed by converting the cost of acquisition, expenditure incurred wholly and exclusively in connection with such transfer and the full value of the consideration received or accruing as a result of the transfer of the capital asset into the same foreign currency as was initially utilised in the purchase of the shares or debentures, and the capital gains so computed in such foreign currency shall be reconverted into Indian currency, so however, the aforesaid manner of computation of capital gains shall be applicable in respect of capital
gains accruing or arising from every re-
investment thereafter in, and sale of,
shares in or debentures of, an Indian
company.

Explanation : For the purpose of this clause,

i) "non-resident Indian" shall have the same
meaning as in clause (e) of section 115C;

ii) "foreign currency" and "Indian currency"
shall have the meanings respectively
assigned to them in section 2 of the
Foreign Exchange Regulation Act, 1973
(46 of 1973);

iii) the conversion of Indian currency into
foreign currency and the reconversion
of foreign currency into Indian currency
shall be at the rate of exchange pres-
cribed in this behalf.

Cost with reference to certain modes of acquisition.

49. (2) Where the capital asset being a share or
shares in an amalgamated company which
is an Indian company becomes the property
of the assessee in consideration of a
transfer referred to in clause (vii) of
section 47, the cost of acquisition of
the asset shall be deemed to be the cost of acquisition to him of the share or shares in the amalgamating company.

(3) Notwithstanding anything contained in sub-section (1), where the capital gain arising from the transfer of a capital asset referred to in clause (iv) or, as the case may be, clause (v) of section 47 is deemed to be income chargeable under the head "Capital Gains" by virtue of the provisions contained in section 47A, the cost of acquisition of such asset to the transferee company shall be cost for which such asset was acquired by it.

Advance money received.

51. Where any capital asset on any previous occasion is the subject of negotiations for the transfer, any advance or other money received and retained by the assessee in respect of such negotiations shall be deducted from the cost for which the asset was acquired or the written down value or the fair market value, as the case may be, in computing the cost of acquisition.
VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

ANNEXURES:II
EXTRACT FROM WEALTH TAX ACT 1957 AND
WEALTH TAX RULES 1957.

1990
7. (1) Subject to any rules made in this behalf, the value estimated to be/the price which in the opinion of the Wealth Tax Officer would fetch if sold in the market on the valuation date.

Explanation: For the removal of doubts, it is hereby declared that the price consideration for which any property may be acquired by or transferred by any person under the terms of a deed of trust or through or under any respective covenant in any instrument of transfer shall be ignored for the purpose of determining the price such property would fetch if sold in the open market on the valuation date.

(2) Notwithstanding anything contained in sub section (i) -

a) where the assessee is carrying on a business
for which accounts are maintained by him regularly the Wealth tax officer, may, instead of determining separately the value of each asset held by the assessee as such business, determine the net value of the assets of the business as a whole having regard to the balance sheet of such business as on the valuation date and making such adjustments therein as may be prescribed.

b) Where the assessee carrying on the business is a company not resident in India and a computation in accordance with clause (a) cannot be made by reason of the absence of any separate balance sheet drawn up for the affairs of such business in India, the Wealth Tax Officer may take the net value of the assets of the business in India to be that proportion of the net value of the assets of the business as a whole wherever carried on, determined as aforesaid as the income arising from the business in India during the year ending with the valuation date bearing to the aggregate income from the business wherever arising during that year.
The Wealth Tax Rules 1957

1A In these rules, unless the context otherwise requires,


g) "investment company" means a company whose gross total income consists mainly of income which is chargeable to income tax under the heads "Interest on securities", "Income from house property", "Capital Gains" and "Income from other sources."

Explanation: In this clause, the expression "Gross total income" means the total income computed in accordance with the provisions of the Income tax Act, 1961 before making any deduction under Chapter VIA of that Act.

h) managing agency company means a company the entire income of which or any part thereof is derived by way of managing agency;

i) "preference shares" has the meaning assigned to it in section 85 of the companies Act, 1956 (1 of 1956).

j) "recognised stock exchange" has the meaning assigned to it in clause (f) of section 2 of
the Securities Contracts (Regulation) Act, 1956 (42 of 1956).

1) "unquoted share" means an equity share or a preference share of a company, other than any such share, the value of which is regularly quoted at any recognised stock exchange;

The following two new clauses (1) and (1a) was proposed to be substituted for the existing clause (1) vide the Wealth Tax Draft (Amendment) Rules, 1981, w.e.f. 1.4.1982:

1) "share regularly quoted on the stock exchange" in relation to an equity share or a preference share of a company, means-

i) a share quoted on any recognised stock exchange in India with regularity from time to time; and

ii) the quotations of such share are based on current transactions made in the ordinary course of business;

1a) "unquoted share" means an equity share or a preference share which is not regularly quoted on any recognised stock exchange in India and includes a share deemed to be an
unquoted share under the explanation to rule 1B;

Market value of unquoted preference shares.

1C 1) Subject to the provisions of sub rule (2) the market value of an unquoted preference share of any company shall -

(a) where the preference share is issued before the valuation date at a rate of dividend of not less than eight percent, be the paid up value of such share; and

(b) where the preference share is issued before the valuation date at a rate of dividend of less than eight percent, be the adjusted paid up value of such share.

2) Where no dividend has been paid in respect of an unquoted preference share by any company continuously for not less than three accounting years ending on the valuation date or in a case where the accounting year of that company does not end on the valuation date, for not less than three continuous accounting years ending on a date immediately before the
valuation date, the paid up value or the adjusted paid up value, as the case may be, shall be reduced:

(a) in the case of non cumulative preference share, as indicated in the Table below:

<table>
<thead>
<tr>
<th>Number of accounting years ending on the valuation date or in a case where accounting year does not end on the valuation date, the number of accounting years ending on a date immediately preceding the valuation date, for which no dividend has been paid</th>
<th>Rate of reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three years</td>
<td>10 percent of the paid up value or the adjusted paid up value, as the case may be</td>
</tr>
<tr>
<td>Four years</td>
<td>20 -do-</td>
</tr>
<tr>
<td>Five years</td>
<td>30 -do-</td>
</tr>
<tr>
<td>Six years &amp; above</td>
<td>40 -do-</td>
</tr>
</tbody>
</table>

(b) in the case of a cumulative preference share, one half of the rates specified in the aforesaid Table.
Explanation: For the purposes of this rule, "adjusted paid up value" in relation to a preference share, means an amount which bears to the paid up value of the preference share, the same proportion as the stipulated rate of dividend (being the rate of dividend on the preference share specified in the terms of issue of such share, and in a case where such dividend is required to be increased under the provisions of section 3 of the Preference Shares (Regulation of Dividends) Act, 1960 (63 of 1960) the rate of dividend as so increased) on such share bears to the rate of eight percent.

Market value of unquoted equity shares of companies other than investment companies and managing agency companies.

1D. The market value of an unquoted equity share of any company, other than an investment company or a managing agency company shall be determined as follows:

The value of all the liabilities as shown in the balance sheet of such company shall be
deducted from the value of all its assets shown in that balance sheet. The net amount so arrived at shall be divided by the total amount of its paid up equity share capital as shown in the balance sheet. The resultant amount multiplied by the paid up value of each equity share shall be the break up value of each unquoted equity share. The market value of each such share shall be 85 percent of the break up value so determined:

Provided that where, in respect of any equity share, no dividend has been paid by such company continuously for not less than three accounting years ending on the valuation date or in a case where the accounting year of that company does not end on the valuation date, for not less than three continuous accounting years ending on a date immediately before the valuation date the market value of such share shall be as indicated in the Table below:
### THE TABLE

<table>
<thead>
<tr>
<th>Number of accounting years ending on the valuation date or in a case where the accounting year does not end on the valuation date, the number of accounting years ending on a date immediately preceding the valuation date, for which no dividend has been paid</th>
<th>Market value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Three years</td>
<td>82 percent of the break up value of such share</td>
</tr>
<tr>
<td>Four years</td>
<td>80 -do-</td>
</tr>
<tr>
<td>Five years</td>
<td>77½ -do-</td>
</tr>
<tr>
<td>Six years &amp; above</td>
<td>75 -do-</td>
</tr>
</tbody>
</table>

#### Explanation I:
For the purposes of this rule, "Balance sheet", in relation to any company, means the balance sheet of such company as drawn up on the valuation date and where there is no such balance sheet, the balance sheet drawn up on a date immediately preceding the valuation date and in the absence of both, the balance sheet drawn up on a date immediately after the valuation date.
Explanation II: For the purposes of this rule -

(i) the following amounts shown as assets in the balance sheet shall not be treated as assets, namely:

a) any amount paid as advance tax under section 18A of the Indian Income Tax Act, 1922 (11 of 1922), or under section 210 of the Income Tax Act, 1961 (43 of 1961);

b) any amount shown in the balance sheet including the debit balance of the profit and loss account or the profit and loss appropriation account which does not represent the value of any asset;

(ii) the following amount shown as liabilities in the balance sheet shall not be treated as liabilities namely:

a) the paid up capital in respect of equity shares;

b) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the valuation date at a general body meeting of the company;
c) reserves, by whatever name called other than those set apart to wards depreciation;

d) credit balance of the profit and loss account;

e) any amount representing provision for taxation other than the amount referred to in clause (i) (a) to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto.

f) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares.

The following new rules 1D and 1E was proposed to be substituted for existing rule 1D vide the Wealth Tax Draft (Amendment) Rules, 1981, w.e.f. 1.4.1982:

Valuation of unquoted equity shares of companies other than investment companies.

1D 1) For the purposes of sub section (1) of Section 7, the value of an unquoted equity share of a
company, other than an investment company, shall be determined in the following manner namely:

(i) the value of all the liabilities as shown in the balance sheet of such company shall be deducted from the value of all its assets as shown in the balance sheet;

(ii) the net amount as arrived at in accordance with clause (i) shall be divided by the total amount of its paid up equity share capital as shown in the balance sheet;

(iii) the amount as arrived at in accordance with clause (ii) shall be multiplied by the paid up value of each equity share and the resultant amount shall be the break up value of such share;

(iv) the break up value of the share so arrived at in accordance with clause (iii) shall be reduced or increased, as the case may be, by an amount calculated as hereunder to arrive at the value of the unquoted equity share of the company, namely:-
a) Where the average distributed income does not exceed five percent of the paid up capital and reserves, the break up value shall be reduced by an amount equal to twenty percent thereof;
b) Where the average distributed income exceeds five percent, but does not exceed ten percent, of the paid up capital and reserves, the break up value shall be reduced by an amount equal to ten percent thereof;
c) Where the average distributed income exceeds ten percent, but does not exceed twenty percent of the paid up capital and reserves, the break up value shall be increased by an amount equal to ten percent thereof;
d) Where the average distributed income exceeds twenty percent of the paid up capital and reserves, the break up value shall be increased by twenty percent thereof.
Explanation: For the purposes of this rule and rule 1E, -

i) assets includes property of every description, movable or immovable, owned by the company, but does not include -

a) any amount paid as advance tax under section 209A or section 210 of the Income Tax Act, 1961 (43 of 1961);

b) any amount shown in the balance sheet including the debit balance of the profit and loss account or the profit and loss appropriation account which does not represent the value of any assets;

ii) "average distributable income" means the average of the distributable income of the company for the accounting year ending with the valuation date for which the relevant balance sheet has been drawn up and the distributable income of two immediately preceding accounting years;

iii) "balance sheet" in relation to any company, means the balance sheet of such company drawn up on the valuation date and where there is no such balance sheet, the balance sheet drawn up on a date immediately preceding the valuation
date and in the absence of both, the balance sheet drawn up on a date immediately after the valuation date;

iv) "distributable income", in relation to an accounting year of a company, means its income as per its profit and loss account of that year as increased by the amount of any reserves or provisions not allowable as a deduction under the Income Tax Act and as reduced by:-

a) any tax payable in respect of the income of increased (sic) under the Income Tax Act, 1961 (43 of 1961) and the Companies (Profits) Surtax Act, 1964 (7 of 1964); and

b) any amount set apart by the company out of the profits of the said accounting year for payment of dividends in respect of its preference share capital;

v) "liabilities" includes all debts owned by a company but does not include -

a) the paid up capital in respect of equity shares;

b) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared
c) reserves, by whatever name called, other than those set apart towards depreciation;

d) credit balance of the profit and loss account;

e) any amount representing provision for taxation to the extent if it exceeds the amount representing the difference between the tax payable with reference to the book profits of the company and the amount of advance tax paid during the financial year immediately preceding the assessment year relevant to the accounting year;

f) any amount representing the contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares.

(2) The value of unquoted equity share of a subsidiary company shall be valued in accordance with the provisions of sub rule (1), with the following modifications, namely:

a) in clause (i) after the words "value of all its assets", the words "which they
would fetch if sold in the market on the valuation date, or in case any rules are made for the valuation of any asset, at the value arrived at in accordance with such rule shall be inserted;

b) the net amount as arrived at in accordance with clause (i) shall be further reduced by an amount equal to twenty five percent of the accumulated profits of the company as appearing in the balance sheet by way of notional tax liability on the distribution of dividends to the holding company.

Explanation: For the purpose of this sub rule, -

1) "accumulated profits" shall have the meaning assigned to it in explanation 2 to clause (22) of section 2 of the Income Tax Act, 1961 (43 of 1961) so far as it relates to sub clause (c) of that clause;

ii) "subsidiary company" shall have the meaning assigned to it in sub clause (ii) of clause (b) of sub section (I) of section 4 of the Companies Act, 1956 (1 of 1956);
3) Nothing contained in this rule shall apply -

a) where, having regard to the facts and circumstances of the case, the Wealth Tax Officer, with the previous approval of the Inspecting Assistant Commissioner, is of the opinion that it would not be practicable or realistic to apply the provisions of this rule to such a case;

b) where there is an increase or reduction in the equity share capital of the company between the date of the balance sheet of the company referred to in clause (iii) of the Explanation to sub rule (I) and the valuation date;

c) to any assessment year commencing before the 1st day of April, 1982.

Valuation of unquoted shares of investment companies.

1E 1) For the purpose of sub section (I) of section 7, the valuation of an unquoted equity share of an investment company shall be determined in the following manner, namely :-
i) the value of all the liabilities including such liabilities which are not reflected in the balance sheet of the company shall be deducted from the value of all its assets which they would fetch if sold in the market on the valuation date, or in case any rules are made for the valuation of any asset, at the value so determined in accordance with such rules;

ii) the net amount as arrived at in accordance with clause (i) shall be divided by the total amount of its paid up equity share capital as shown in the balance sheet;

iii) the amount as arrived at in accordance with clause (ii) as multiplied by the paid up value of each equity share shall be the value of the unquoted equity share of an investment company.

2) Nothing contained in this rule shall apply to any assessment year commencing before the 1st day of April, 1982.

Explanation: For the purpose of rule 1D and this rule, where the quotation in respect of
any equity share on a recognised stock exchange in India is found to be less than two thirds of the value arrived at in accordance with the provisions of rule 1D or this rule, as the case may be, such a share shall be deemed to be an unquoted share.

Determination of the net value of assets of business as a whole.

2A. Where the Wealth Tax Officer determines under clause (a) of sub-section (2) of section 7 the net value of the assets of the business as a whole having regard to the balance sheet of such business he shall make the adjustments specified in rules 2B, 2C, 2D, 2E, 2F and 2G.

Adjustments in the value of an asset disclosed in the balance sheet.

2B. 1) The value of an asset disclosed in the balance sheet shall be taken to be -
   a) in the case of an asset on which depreciation is admissible its written down value;
   b) in the case of an asset on which no depreciation is admissible its book value;
c) in the case of closing stock, its value adopted for the purposes of assessment under the Income Tax Act, 1961, for the previous year relevant to the corresponding assessment year.

2) Notwithstanding anything contained in sub rule (1) where the market value of an asset exceeds its written down value or its book value or the value adopted for purposes of assessment under the Income tax Act, 1961, as the case may be, by more than 20 percent, the value of that asset shall, for the purposes of rule 2A, be taken to be its market value.

Adjustments in the value of an asset not disclosed in the balance sheet.

2C. The value of an asset not disclosed in the balance sheet shall be taken to be -

a) in the case of a debt due to the assessee, the amount due to the assessee under that debt, and where such amount or part thereof has been allowed as a deduction under clause (vii) of sub section (1) of section 36 of the Income Tax Act, 1961, in computing
the total income of the assessee for the relevant year for the purposes of assessment under that Act, the amount of the debt as reduced by the deduction to be allowed.

b) in the case of goodwill purchased by the assessee for a price, its market value or the price actually paid by him, whichever is less;

c) in the case of managing agency rights purchased by the assessee for a price, its market value or the price actually paid by him, whichever is less;

d) in the case of any other asset, its market value on the valuation date.

Value of certain assets not to be taken into account.

2D. The value of the following assets which are disclosed in the balance sheet shall not be taken into account for the purposes of rule 2A:

a) any amount paid as advance tax under section 18A of the Indian Income Tax Act, 1922, or under section 210 of the Income Tax Act, 1961;
b) the debt due to the assessee according to the balance sheet or part thereof which has been allowed as a deduction under clause (vii) of sub section (1) of section 36 of the Income Tax act, 1961, for the purposes of assessment for the previous year relevant to the corresponding assessment year under that Act;

c) the value of any asset in respect of which wealth tax is not payable under the Act;

d) any amount shown in the balance sheet including the debit balance in the profit and loss account or the profit and loss appropriation account which does not represent the value of any asset.

Value of certain liabilities not to be taken.

2E. The following amounts shown as liabilities in the balance sheet shall not be taken into account for the purposes of rule 2A:

a) Capital employed in the business other than that attributable to borrowed money;
b) reserves by whatever name called;

c) any provision made for meeting any future or contingent liability;

d) any debt owned by the assessee which has been specifically utilised for acquiring an asset in respect of which wealth tax is not payable under the Act:

Provided that where it is not possible to calculate the amount of debt so utilised, it shall be taken as the amount which bears the same proportion to the total of the debts owed by the assessee, as the value of that asset bears to the total value of the assets of the business.

Explanation: Provision for any purpose other than taxation shall be treated as a reserve.

Liabilities not disclosed in the balance sheet.

2 F Any debt relating to the business owed by the assessee, which is not disclosed in the balance sheet, shall be allowed as a deduction for the purposes of rule 2A:
Provided that a contingent liability shall not be treated as a debt owed.

Special provision for exclusion of certain assets and liabilities shown in the balance sheet.

2G 1) Notwithstanding anything contained in rule 2B, 2D and 2E but subject to sub rule (2), where the Wealth tax Officer is of the opinion that any asset, or liability which is a debt, owed by the assessee shown in a balance sheet does not really pertain to the business as such, he may exclude the value of the asset or the debt for the purposes of rule 2A.

2) The value of any such asset or debt shall be taken into account for the purposes of assessment of wealth tax under any provision of the Act other than sub section (2) of section 7, if it is so provided.
VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

RELEVANT PROVISIONS OF WEALTH TAX ACT (As amended by Direct Taxes Amendment Act 1989)

1990
Value of assets how to be determined?

7(1) Subject to the provisions of sub section (2), the value of any asset, other than cash, for the purposes of this Act shall be its value as on the valuation date determined in the manner laid down in Schedule III.

SCHEDULE - III
(See Section 7(1))
Rules for determining the value of assets
PART A
General.

Value of assets how it is to be determined?

1. The value of any asset, other than cash, for the purposes of this Act, shall be determined in the manner laid down in these rules.

2. In this Schedule, unless the context otherwise requires;

Definitions:
1) "accounting year" in relation to a company means a period in respect of which any profit and loss account of the company laid before it in the annual general meeting is made up;

2) "debenture" includes debenture stock, bonds and any other securities of a company, whether constituting a charge on the assets of the company or not;

3) "equity share" means any share in the share capital of a company other than a preference share.

6) "investment company" means a company whose gross total income consists mainly of income which is chargeable to income-tax under the heads "Income from house property", "Capital gains" and "Income from other sources."

Explanation: In this clause, the expression "gross total income" shall have the meaning assigned to it in section 80B of the Income-tax Act. (Gross total income is defined in sec. 80B (5) as "gross total income" means..."
the total income computed in accordance with the provisions of this Act, before making any deduction under this Chapter).

8) "preference share" has the meaning assigned to it in section 85 of the Companies Act, 1956;

9) "quoted share" or "quoted debenture", in relation to an equity share or a preference share or, as the case may be, a debenture means a share or debenture quoted on any recognised stock exchange with regularity from time to time, where the quotations of such shares or debentures are based on current transactions made in the ordinary course of business.

Explanation: Where any question arises whether a share or debenture is a "quoted share" or a "quoted debenture" within the meaning of this clause, a certificate to that effect furnished by the concerned stock exchange in the prescribed form shall be accepted as conclusive;
10) "recognised stock exchange" has the meaning assigned to it in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956.

11) "unquoted share" or "unquoted, debenture", in relation to an equity share or a preference share or, as the case may be, a debenture, means a share or debenture which is not a quoted share or a quoted debenture.

PART C

Shares in or debentures of Companies.

Quoted shares and debentures of companies.

9. The value of an equity share or a preference share in any company or a debenture of any company which is a quoted share or a quoted debenture shall be taken as the value quoted in respect of such share or debenture on the valuation date or where there is no such quotation on the valuation date, the quotation on the date closest to the valuation date and immediately preceding such date.
9A. Special provisions for quoted shares of Companies -

Notwithstanding anything in rule 9, the value of an equity share in any company which is a quoted share may, at the option of the assessee, be taken on the basis of the average of the value quoted on the 31st day of March immediately preceding the assessment year and the values quoted in respect of such share on the said dates in relation to each of the immediately preceding four assessment years, or where there is no such quotation on any of the aforesaid dates, the quotation on the date closest to the said date and immediately preceding such date;

Provided that where for any reason the value of such share is quoted in relation to lesser number of assessment years than the said four assessment years, then the value or values so quoted shall be taken into account for the purposes of the aforesaid average;

Provided further that where the assessee opts for the average of the values so quoted, he shall get such values certified by an accountant and attach the certificate to the return of wealth in respect of the relevant assessment year.
Explanation: For the purposes of this rule, "accountant" shall have the same meaning as in the Explanation below sub-section (2) of section 288 of the Income-tax Act.

b) in rule 12, sub rule (3) and (5) shall be omitted and shall be deemed to have been omitted with effect from the 1st day of April, 1989.

Unquoted preference Shares:

10(1). Subject to the provisions of sub-rule (2), the value of unquoted preference share in any company shall -

a) Where the preference share is issued before the valuation date at a rate of dividend of not less than eight per cent, be the paid-up value of such share; and

b) Where the preference share is issued before the valuation date at a rate of dividend of less than eight per cent, be the adjusted paid-up value of such share.

(2) Where no dividend has been paid in respect of an unquoted preference share by any company
continuously for not less than three accounting years ending on the valuation date or, in a case where the accounting year of the company does not end on the valuation date, for not less than three continuous accounting years ending on a date immediately before the valuation date, the paid-up value or, as the case may be, the adjusted paid-up value shall be reduced -

a) in the case of a non-cumulative preference share as indicated in the Table below:-

TABLE

<table>
<thead>
<tr>
<th>Number of accounting years ending on the valuation date or, in a case where the accounting year does not end on the valuation date, the number of accounting years ending on a date immediately preceding the valuation date, for which no dividend has been paid.</th>
<th>Rate of reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three years</td>
<td>10 percent of the paid-up value or the adjusted paid-up value, as the case may be</td>
</tr>
<tr>
<td>Four years</td>
<td>20</td>
</tr>
<tr>
<td>Five years</td>
<td>30</td>
</tr>
<tr>
<td>Six years &amp; above</td>
<td>40</td>
</tr>
</tbody>
</table>
b) In the case of a cumulative preference share, by one half of the rates specified in the aforesaid Table.

Explanation: For the purposes of this rule, "adjusted paid-up value", in relation to a preference share, means an amount which bears to the paid-up value of the preference share the same proportion as the stipulated rate of dividend, (being the rate of dividend on the preference share specified in the terms of issue of such share, and in a case where such dividend is required to be increased under the provisions of section 3 of the Preference Shares (Regulation of Dividends) Act, 1960, the rate of dividend as so increased) on such share bears to the rate of eight per cent.

Unquoted equity shares in companies other than investment companies.

11. 1) The value of the unquoted equity share in any company, other than an investment company, shall be determined in the manner set out in sub-rule (2).
2) The value of all the liabilities as shown in the balance sheet of such company shall be deducted from the value of all its assets shown in that balance sheet the net amount so arrived at shall be divided by the total amount of its paid-up equity share capital as shown in the balance sheet; the result multiplied by the paid-up value of each equity share shall be the break-up value of each unquoted equity share, and an amount equal to eighty per cent of the break-up value so determined shall be the value of unquoted equity share for the purposes of this Act.

3) For the purposes of sub-rule (2)

a) the following amounts shown as assets in the balance sheet shall not be treated as assets, namely:-

i) any amount paid as advance tax under the Income-tax Act;

ii) any amount shown in the balance-sheet including the debit balance of the profit and loss account or the profit and
loss appropriation account which does not represent the value of any asset;

b) the following amounts shown as liabilities in the balance sheet shall not be treated as liabilities, namely:

i) the paid-up capital in respect of equity shares;

ii) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the valuation date at a general body meeting of the company.

iii) reserves, by whatever name called, other than those set apart towards depreciation;

iv) credit balance of the profit and loss account;

v) any amount representing provision for taxation, other than the amount referred to in sub-clause (i) of clause (a) to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;
vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares.

Explanation - For the purposes of this rule, "Balance-sheet", in relation to any company, means the balance-sheet of such company (including the Notes annexed thereto and forming part of the accounts) as drawn up on the valuation date and, where there is no such balance sheet, the balance sheet drawn up on a date immediately preceding the valuation date, and, in the absence of both, the balance sheet drawn up on a date immediately after the valuation date.

Unquoted equity shares in investment companies:

12(1) Subject to rule 13, the value of an unquoted equity share in an investment company shall be determined in the manner specified in sub-rule (2)

(2) The value of all the liabilities as shown in the balance-sheet of such company shall be deducted from the value of all its assets shown in that balance-sheet; the net amount so arrived at shall be divided by the total paid-up equity
share capital of the company as shown in the balance sheet, and the result multiplied by the paid-up value of each equity share shall be the value of the unquoted equity share in that investment company for the purposes of this Act.

(3) For the purposes of sub-rule (2), the value of an asset disclosed in the balance-sheet of the company shall be taken to be its value determined in accordance with the rules as applicable to that particular asset and, in the absence of any such rule, the value of such asset shall be its value as determined under rule 20.

Omitted by Direct Tax Laws (Second Amendment) Act 1989 w.e.f. 1.4.'89.

(4) For the purposes of this rule,

a) "balance sheet" has the same meaning as in rule 11;

b) the amounts referred to in sub-rule (3) of rule 11 shall not be treated as assets or liabilities.

(5) For the purpose of facilitating the valuation of unquoted equity shares under this rule and rule 13,
the company concerned shall have such valuation made by its auditors appointed under section 224 of the Companies Act 1956, and a certificate of the auditors relating to such valuation in the prescribed form shall be furnished to the Assessing Officer in the case of the company, and the valuation made by the auditors shall be taken into account in the assessments of the shareholders of the Company.

(omitted by Direct Tax Laws (Second Amendments) Act 1989, w.e.f. 1.4.1989.)

Unquoted equity shares in interlocked companies:

13(1) The value of an unquoted equity share in one of the two interlocked companies held by the other interlocked company for the purposes of rule 12 shall be equal to the paid-up value of such share or the value determined under sub-rule (2) whichever is higher.

(2) For the purpose of sub-rule (1), the aggregate value of all the equity shares in an interlocked company shall be arrived at by multiplying the maintainable profits of such company by -
a) the fraction $\frac{110}{8.5}$ in a case where the gross total income of the company consists, to the extent of not less than 51 per cent of income chargeable under the head "Income from house property"; or

b) the fraction $\frac{100}{10}$, in the case of any other interlocked company.

and the resultant amount divided by the number of such equity shares shall be the value of such an equity share in such company.

(3) The maintainable profits of the company, for the purpose of sub rule (2) shall be computed in the following manner namely:

a) the book profits of the company for the five accounting years of the company immediately preceding the valuation date shall first be ascertained;

b) adjustments shall be made to the book profits for each of the said five years for all non-recurring and extraordinary items of income and expenditure and losses;
c) adjustments shall be made to the book profits for expenditure which is not of a revenue nature but is debited in the account and for receipts which are in the nature of revenue receipts but are not accounted for in the profit and loss account.

d) any development rebate or investment allowance debited in the books of account shall be added back to the book profits.

e) the tax liability of the company on the book profits, arrived at after the adjustments at items (a), (b), (c) and (d), shall be deducted from such book profits.

f) amounts required for paying dividends on preference share or shares with prior rights shall be deducted from such book profits.

g) the aggregate of the book profits for the five accounting years so arrived at, divided by 5, shall be the maintainable profits of the company.

Explanation - for the purposes of this rule "interlocked companies" means any two investment companies each of which holds shares in the other company.
ANNEXURE - III-A

PROVISIONS OF GIFT TAX ACT

Value of Gifts, how determined:

6(1) Subject to the provisions of sub-section (2),
the value of any property, other than cash,
transferred by way of gift shall for the pur‐
pose of this Act, be its value as on the date
on which the gift was made and shall be
determined in the manner laid down in
Schedule II.

(2) Where a person makes a gift which is not re‐
vocable for a specified period, the value of
the property gifted shall be the capitalised
value of the income from such property during
the period for which the gift is not
revocable.

SCHEDULE II
(See section 6(1)
Rules for determining the value of pro‐
erty gifted

Value of gifted property, how to be determined?

The value of any property, other than cash,
transferred by way of gift shall, for other
purposes of this Act, be determined in accordance with the provisions of Schedule III to the Wealth-tax Act, which shall apply subject to the following modifications, namely:

In the said Schedule –

a) references, by whatever form of words to the Wealth-tax Act shall be construed as reference to this Act;

b) in rule 5, the reference to the year ending on the valuation date shall be construed as a reference to the previous year as defined in this Act;

c) save as provided in clause (b), references to the valuation date shall be construed as reference to the date on which the gift was made;

d) reference to section 7 of the Wealth-tax Act shall be construed as references to section 6 of this Act;

e) references to section 16A of the Wealth-tax Act shall be construed as references to subsection (6) of section 15 of this Act.
VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

ANNEXURES: IV

PART I: MAINTAINABLE PROFIT BASIS OF VALUATION.

1990
PART - I

MAINTAINABLE PROFIT BASIS OF VALUATION

Under this method a reasonable estimate of the average future maintainable profits is made by taking past earnings, their trend and the future plans of the company as guides. This estimated future average maintainable profit after deducting the preferred claims, if any, is capitalised at an appropriately selected rate and the resultant is divided among the different classes of equity shares.

In a number of Court cases the importance of this basis has been emphasised. In Fairfax v. Commissioner of Stamps 18, W.N. (N.S.W.) 255, it was observed that "in my view the most satisfactory basis on which to make the necessary investigation as to the value is to consider first the figures showing the earning power of the company at the relevant dates." Similarly in Borg v. International Selver Co. (1925) an American case, it was held that, "Every one knows that the value of shares of a commercial or manufacturing company depends chiefly on what they will

* Extracted from "A Study on Share Valuation"
1. Fairfax v. Commissioner of Stamps 18, W.N. (NSW) 255.
2. Borg v. International Selver Co. (1925) USA.
earn, on which balance sheets throw little light."

In the case of Ahlenime v. Bunn. L. Humphreys (1934)\(^1\) of that country, the Court went to the extent of saying that, "Mere book value should not govern in determining the value of shares of objecting stockholders and appraised values are necessarily controlling. The use of book value, especially, to measure the value of corporate shares owing to multifarious uses for which they are employed, is generally condemned as unsound." In several cases, the profits basis has been held to be more appropriate than the assets basis. Thus in Tolley's case\(^2\), it was observed that, "I think buyers and sellers in the open market would be more directly influenced by the apparent earning power than by complex calculations on net assets, but those assets would be regarded generally for assurance that returns would be maintained."

Similarly in Murdoch's case\(^3\) it was held that, "The main items to be taken into account in valuing shares are the earning power of the company, and the safety of the capital assets in which the shareholders' money is invested."

---

1. Ahlenime v. Bunn. L. Humphreys (1934) USA.
PROCEDURE:

The approach to valuation of shares on this basis would need determination of two factors viz. (1) future maintainable profits and (2) the rate of capitalization.

FUTURE MAINTAINABLE PROFITS:

Determination of future maintainable profits is a complicated and delicate task as it involves not only the objective consideration of the available financial information but also subjective evaluation of many other factors, such as capabilities of the company's management, general economic conditions, future government policies, etc. Guiding principles may be laid down here only in respect of the former and the valuer will have to give due consideration to the latter matters according to his reading of the situation in each individual case.

Three steps are necessary to arrive at the future maintainable profits of a company: (a) calculation of past average earnings; (b) projection of the future maintainable profits and (c) adjustment of preferred rights. These steps are discussed in some detail below:
a) Calculation of the Past Average Earnings:

In order to calculate the past average earnings, it is necessary to decide upon the number of years whose results should be taken for averaging, select these years, and adjust their profits to make them acceptable for averaging.

The number of years to be selected must be reasonably large enough so as to cover generally the length of a business cycle (which would include recovery, peak and recession phases of the cycle), as an average for a shorter period might not be a fair average. This could apply only if the business is subject to cyclical fluctuations. This period, if selected in the aforesaid manner, gets closer to the average future earnings. In inflationary conditions present today, there is however often more value in a shorter, say 3-yearly average than in the average of a long period. Similarly for companies having a steady and gradual growth, average of a shorter period is more useful. In some unusual circumstances, average of a still shorter period or even one year's profit may be of more significance in predicting future earnings, such as
where a change in the business or a change in training conditions force the valuer to discard earlier years and to rely upon one year only or to select certain normal years and exclude others. In all these matters a sound reasoning could alone aid the valuer.

Whether a 3-yearly, 5-yearly or longer average would reflect the correct future earnings of a company mostly depends upon the nature of the individual case and the length and nature of the business cycle in the industry in which the company is operating.

Selection of the period for averaging past profits to serve as a guide to the projection of maintainable profits has received attention in McCathie's case. Profit of one year immediately before valuation date was selected to serve as guide to future projection. The preceding three years were excluded from consideration because they were lean years due to structural alterations being carried out in the business.

In Martin's case future maintainable average profit was projected on the basis of past three-yearly

2. Kent and Martin vs. Federal Commissioner of Taxation (Not Reported)
Adapted from Adamson's "Valuation of Company shares and Business" (1966) - page 111.
average profit both by the witness and by the court.

In Clifford's case the court adopted a five-yearly average as basis for projecting maintainable average profit.

The years chosen for averaging the past earnings of the company should be normal years. But in an expanding economy like India, where most of the companies are engaged in expansion programmes, and have been faced with recession, there is hardly any year in the recent history of any such company without some material changes, which could be called a normal year. In case the events occurring in a year could be so adjusted as not to distort the estimated past average profit, the year is included as normal. If the events in a year are such as would yield, so distorted an average, even after making adjustments, the year is excluded as abnormal. If the company has incurred a loss in a particular year, it does not necessarily become an abnormal year.

There are some necessary adjustments to be carried out in averaging the past earnings. Even though the companies Act 1956, makes it obligatory on the part

of the companies to disclose a true and fair view of the profit or loss in their accounts (which are the primary source of information for this method of valuation) there is still necessity for some adjustments which the valuer must consider, to make the future average maintainable profits more reliable. More important of such adjustments are as follows:

i) Elimination of material non-recurring items such as loss of exceptional nature through strikes, fires, floods and theft etc., profit or loss of any isolated transaction not being part of the business of the company, lump sum compensation or retiring allowance, damages and costs in legal actions, abnormal repair charges in a particular year, receipt of commission for a special service, etc.

ii) Elimination of profits or losses from investments which are not regarded as part of the main business of the company. Such profit or loss should, however, be separately considered and included in the total earnings of the company.

iii) Elimination of any capital profit or loss or receipt or expense which may have been taken into the profit and loss account.
iv) Adjustment for any interest, remuneration, commission etc., foregone by directors or others or by the company.

v) Adjustments for any matters suggested by notes appended to the accounts or by qualifications in the auditors' report, such as provision for bad and doubtful debts, gratuities, etc.

vi) In the case of depreciation it should be ensured that the provision in each year is adequate and is calculated consistently both as to basis and rates.

vii) In the case of stocks also it should be ensured that the basis of valuation is consistent from year to year.

viii) The past average profit should be calculated after deducting tax at current rates. This may be done by applying the current tax rates applicable to the past years' profits arrived at after making all other adjustments. Average rate at which surtax has been paid by the company during the past few years should be included with the rate of tax. No account should be taken of any rebates or reliefs such as development rebate/allowance,
rebate on export profits, relief to new industrial undertakings/hotels or on dividends from companies having the same, and relief due to accumulated losses. Tax on dividends and on bonus shares should also be disregarded. All these matters will however be considered when projecting future profits, as discussed at a later stage.

In the computation of maintainable average profit, the courts have in a number of cases, made the following adjustments and rejections:

i) In Abraham's case the judgement approved of estimated additional income from idle cash being included in future maintainable profits.

ii) In McCathie's case Directors fees were reduced to a figure considered to be relevant.

iii) In Martin's case depreciation charge based on the amount allowed for tax purposes, was taken as a fair charge.

iv) Applicable portion of profits and assets of controlled subsidiaries were combined with the

2. McCathie Vs Federal Commissioner of Taxation 69, C.L.R.I.
3. Kent and Martin v Federal Commissioner of Taxation (Not Reported) Adapted from Adamson's "Valuation of Company Shares and Business" (1966) p. 111
profit of the parent company in Martin's case. 1

v) In Cliffords case the Court refused an allowance for loss of a director with exceptional qualities. In Martin's case an allowance for future increase in taxation was disallowed.

In averaging past earnings arrived at as above, consideration has to be given to fluctuations from year to year. In this regard three situations may have to be faced. Where the past profits of a company are widely fluctuating from year to year, an average fails to aid future projections. In such cases the whole history of the company and the study of earnings of a fairly long period may be necessary. If the profits of a company show regular trend (upward or downward) an average of the cycle can usefully be employed for projection of future earnings. In some companies, profits may record a markedly rising or falling trend from year to year. In these circumstances a simple average fails to consider a significant factor, namely, trend in earnings. The shares of a company which records a clear up-trend of past profits would certainly be more valuable than those of a company whose trend

---

1. Kent and Martin v Federal Commissioner of Taxation (Not reported) Adapted from Adamson's "Valuation of Company Shares and Business" (1966), p.111.

of past earnings indicates a static or down-tendency.
In such cases a weighted average giving more weight to
the recent years than to the past, is appropriate. A
simple way of weighing is to multiply the profit by the
respective number of the years arranged chronologically.

b) Projection of the Future Maintainable Profit:

Projection is not as easy matter, because it is
essentially an estimation of what would happen in the
risky and uncertain future. The average profit earned
by a company in the past, could be normally taken as
the average profit that would be maintainable by it in
the future, if the future is considered basically as
a continuation of the past. If future performance of
the company is viewed as departing significantly from
the past, then appropriate adjustments will be called
for before accepting the past average profit as the
future maintainable profit of the company. There are
also certain matters which were excluded when calcul-
ting past average profits, but which should be con-
sidered at this stage. The important adjustments which
may be found necessary are as follows:

i) Discontinuation of part of the business, expansion
programmes and any major change in the policies of the
company may provide occasions for making a break with
the past. So far as discontinuation of a part of the business is concerned, it may be rather easily dealt with by the valuer. The part of the profits earned by such business may be excluded from the future maintainable profit. Reinvestment of funds released from such business, and other expansion schemes will present more complex problems. For these matters the valuer will have to use his judgement about their profitability. The state of execution at the time of valuation should be given due consideration. Mere paper plans for expansion might not be taken into account at all.

If reasonable indications of expected future profit are available, then such profits taken on a conservative basis in order to take care of the greater risk and uncertainty involved, may be included in the future maintainable profit of the company. If, however, the profits are expected to be realised after a lapse of some years or if material amounts have yet to be incurred before profits are realised, due consideration will have to be given to these factors. In such circumstances it may generally be suggested that separate value may be given to such new investments and the same may be added to the value arrived
at by capitalising the normal maintainable profit. The technique of discounted cash flow may be usefully employed in these cases. Both the future expenditure and expected earnings may be discounted to their present work. The earnings rate of the company may be used as the rate of discounting for this calculation. Future earnings in such cases would eventually have to be taken on the basis of expectation of the management. The risk attached to such profits will therefore be higher. The valuer should keep this in view when taking the figures of future earnings or selecting the discounting rate. If the expansion programme has to be financed by issue of further capital, then such capital will obviously be included in the total capital when dividing the total value among the various classes of shares.

Effects of changes in the policy of the company may be taken into account if such changes are known in advance and the effects are capable of being quantified. Changes in the utilisation of the productive capacity, changes in the organisational set-up, changes in the produce-mix, changes in the financing policy are some examples of the situation that may have to be faced by
the valuer. Their treatment in the projection of future profits will depend entirely upon the effect which in the opinion of the valuer, such changes will have on such future profits.

ii) In arriving at the past profit, notional tax calculated at the current rates applicable to the company on the adjusted profit was deducted, without taking into consideration the reliefs and rebates available on account of development rebate etc. In making future projection also, notional tax calculated at the current rates applicable to the company should be deducted. Rebates and reliefs, if any, which the company may be entitled to would be dealt with separately as shown in the next paragraph.

iii) Non-recurring items are also excluded from the calculation of past average profit. But if some non-recurring income or expenditure is sure to be earned or incurred in future, due consideration has to be given for the same. Benefits in the charge of tax due to accumulated losses, development rebates/allowance and relief for new industrial undertakings/hotels also fall into this category. As has been pointed out earlier, the future maintainable profit should not be adjusted because of these non-recurring
items: Instead, they should be considered separately by reducing them to their present worth with the aid of discounted cash flow method, using the earning rate of the company as the rate of discount. This worth should be added to or deducted from the capitalised value of the maintainable profit.

c) Adjustment of Preferred Rights:

In arriving at the average profits and their future projection, all charges including interest on debentures and other borrowings are deducted. But the dividend on preference shares depends upon the availability of divisible profits and therefore should be considered only after the estimate of future profits has been arrived at. Maximum dividends payable to preference shareholders according to the terms of their issue should be deducted from the maintainable profit. For example, in case of participating preference shares, the fixed original dividend has to be taken together with the maximum participation within the limits of the expected dividends out of the estimated future profits. Payments of the arrears of cumulative preference dividends may be spread over the future years on the basis of expected profits available for distribution and such payments may be reduced to
their present worth by discounting them at the earnings rate of the company.

THE RATE OF CAPITALISATION:
The next main step in this method of valuation is the selection of the rate at which the estimated future average maintainable profit is capitalised to arrive at the total value of the equity capital of the company.

The principle behind the selection of this rate is that it should be an aggregate of the long-term risk-free interest rate and of the additional earnings expected to cover the risk involved in the business. It is difficult to select a particular rate as representing the element of risk involved in a particular business. A good guide for the composite rate is however provided by what the financial analysis term as earnings rate. The earnings rate is calculated by dividing the earnings per share by the current market value of such shares (and multiplying the result by 100 to arrive at a percentage). In computing the earnings rate the market quotation of the shares is used under the implicit assumption that the market is perfectly competitive. The implication of the assumption
is that the market price has been a product of the interaction of perfect competitive forces. But in actual life it is not so. The market is imperfect and ill-informed and therefore the market quotation does not always reflect the earning power of the company. Where the stock market is sluggish, though a company's earning capacity has gone up materially the market quotation may still lag behind and thus may not reflect the correct earning power of the company. In an over-active stock market the market quotations are influenced even by rumour. Therefore, too much reliance on market quotations will give an unrealistic rate of capitalisation. Many such general market conditions and other extraneous factors influence the market quotations. Necessary adjustments are to be made in the market quotations before using it to determine the earnings rate. For example if valuation of shares occurs at a point just before declaration of dividends then the market quotation for the shares is generally high. To arrive at a fair value, adjustment for this extraneous factor must be made. In such cases, it would be advisable to take an average of the market quotations, over a period of time.
At the same time no valuer should lightly ignore the ruling market price arrived at by arms length negotiations between the buyer and seller in an open market. After all the expertise which a valuer may bring to bear upon his task, the ultimate test of value is the willingness of the parties to enter into the contract at an agreed price. The evidence of value provided by an open market sale should not therefore be ignored except for the most cogent reasons.

For companies whose shares are quoted on the stock exchanges, the market value, with necessary adjustments for extraneous factors, may be used to obtain the earnings rate whereas in valuing unquoted company shares, selection of earnings rate appropriate to the company presents a difficult problem. In determining the rate of capitalisation, a close analysis is made of the quoted companies operating in the same field as the company under consideration. From this analysis the most closely comparable quoted company, (if available) is selected. The selected company's earnings rate is calculated with the help of adjusted market quotations of its shares and this earnings rate may be employed as an aid to arrive at the proper rate of capitalisation for the unquoted company.
Due allowance has to be made for the disadvantages of an unquoted company such as the non-marketability of the shares and the difference in size between the two types of companies etc.

Cases do arise where the share valuer is unable to discover a reasonably comparable quoted company. Moreover, even in cases of companies which are officially listed on the stock exchange if they are not actively traded, recent market quotation of shares may not be available for computation of earnings rate. In such cases the valuer must apply his reasoning and judgement to the specific history of the industry and the company, profit trend, the risk factor associated with the business of the company, etc., before arriving at a rate of capitalisation.

There may be cases where one company is carrying on two or more different businesses. In such cases it will be more appropriate to determine their maintainable profits separately, and apply the rate of capitalisation appropriate to the individual business.

A distinction is sometimes made between an earnings - capitalisation and a dividend rate of capitalisation. This distinction is made on the ground
that the share-holders get the immediate benefit of profits only to the extent it is distributed as dividend. The benefit to the shareholders in respect of the retained profit is necessarily deferred. The rate of capitalisation used for distributed profits is therefore lower than the rate used for retained profits. It would however appear that from a long-term point of view very little difference could be made in the present worth of the total future dividends provided that the profits retained are used for earning further profits at the usual rate of the company. Therefore if a reasonable amount of the total profits is retained and reinvested properly it should not be necessary to use two different capitalisation rates for profits distributed and profits retained. The reasonableness of the pay-out ratio should take into account the necessity of larger amounts for replacement and maintenance of the present assets as well as a cushion against future contingencies. If larger amounts are retained they would normally be used for expansion, and therefore maintainable profits of the company would be larger. In extreme cases however it may be necessary to take the factor of pay-out ratio into consideration while determining the rate of capitalisation. Such cases would arise where the pay-out
ratio is either exceedingly low, high or where profits retained are not being re-invested and do not ensure a reasonable return in future.

Where a dividend rate of capitalisation is used it is naturally lower than what would apply to the total maintainable profits. But even under this alternative, consideration has to be given to the adequacy and reasonableness of the dividend cover provided by the total profits.

To determine fair value of the shares the estimated future average maintainable profits and/or expected future dividends are capitalised as described above. Present worth of the non-recurring items is thus added to or deducted from this amount as described in the earlier paragraphs.

**FIXATION OF THE VALUES OF THE DIFFERENT TYPES OF EQUITY SHARES:**

If there is only one type of equity shares, then the total value attributable to equity capital, after deduction of all preferred claims, will be distributed among the equity shares. If there are different types of equity shares, having different paid up amounts but
having other equal rights, then the value of the
shares will be fixed in proportion to the paid-up
amounts. Where the rights of the different types of
equity shares are different, the rates will be fixed
depending upon the terms of issue of the shares.
VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

ANNEXTURES: IV

PART - II : ASSETS BASIS OF VALUATION

1990
ASSETS BASIS OF VALUATION

Valuation of shares on assets basis attempts to measure the amount of the assets of the company against each share. It is computed by taking the net value of the company's assets including goodwill subtracting therefrom the face value of the creditors' and preferred shareholders' claims and dividing the remainder among the equity shareholders according to their individual rights.

Referring to the assets basis of valuation in Murdoch's case, Justice Williams said that one of the main items to be taken into account is the safety of the capital assets in which shareholders' fund is invested and in McCathie's case, His Lordship again emphasised that a prudent purchaser takes care to ensure that his purchase money is well secured by tangible assets.

In Abraham v Federal Commissioner of Taxation (70 C.L.R. 23), it was observed that -

"The final assessment of the value of the shares must be made principally on the basis of the

2. McCathie v Federal Commissioner of Taxation 69 C.L.R. 1."
income yield - but owing to exceptional circumstances the valuation on this basis presents enormous difficulties, it is legitimate to rely more than usual on the assets value."

Assets value becomes a very material factor in valuation of shares at extreme ranges where either the tangible assets are very low in relation to the profitability or the net assets' value is very much in excess of the value arrived at on a profit basis. Assets value also provides guide line for valuation of shares of companies whose future profits are in determinable either because of newness, dislocation, losses of the business or due to business fluctuations.

As mentioned in earlier Chapters assets basis has to be used for valuation for certain specific purposes.

The liquidated value of net tangible assets is the minimum value of the whole company and will prevail even if its earning capacity is very low or in the negative. This minimum value is the value calculated on the basis of winding-up. In adopting this liquidation basis for valuation the valuer should give adequate consideration to what Mr. Justice Kennedy
called "reluctance to wind up." In Keeping v. Commissioner of Stamp Duties, he assigned a value of 30% of the net realisation to this factor and added it to the net realisation to arrive at the value of shares. The Judge in the Courthope case in England suggested 33 1/3% of the net realisation to this factor. Costs of liquidation and tax consequences thereof should be taken into account.

PROCEDURE:

The three steps necessary for valuing shares on assets basis are as follows:

1. Valuation of Assets.
2. Ascertainment of liabilities.
3. Fixation of the value of different types of equity shares.
The two problems which present themselves in valuing the assets of a company are whether they should be taken at their book value or realisable value and whether only tangible assets should be taken for this purpose or intangible assets also be taken.

In these times of changing price levels, it is unrealistic to take book values of different assets — particularly fixed assets — of a company if the values have changed materially since the date of their acquisition. In such cases, therefore, realisable value of the assets should be ascertained, if necessary, with the help of expert valuers. Normally such value of assets would be taken after taking into account the cost of realisation as well as the capital gains and other taxes which the company may have to pay on such realisation. An important departure from this principle is found in the Wealth Tax Rules for valuation of unquoted equity shares, which specifically require the assets to be taken at their book value.

Generally the value of the assets will have to be taken on a going concern basis. But there may be cases where it would be reasonable to take the liquidation
value of assets. The points arising from the judgement given in New Zealand Insurance Co. Ltd. v. Commissioner of Inland Revenue, are very illuminating in this regard.

Underlying the assets value there is always a notional liquidation, and in principle that method is generally used to ascertain what would be the net value of the shareholder if liquidation were carried out. Consequently, a deduction equal to the amount of expenses of liquidation is proper in the application of this method.

Intangible assets of the company have also to be included with its other assets, whether they are shown on the books or not. Intangible assets generally consist of goodwill, patents, trade-marks, copyrights, etc. Patents, trade-marks and copyrights can generally be sold as distinct assets separately from the whole business of the company. Therefore their realisable value should be included in the value of the assets. On the other hand goodwill is generally inseparable from the business and it can fetch a price only if the business is sold on a going-concern basis. The valuation of goodwill is a complicated matter and has been discussed in some detail later on in this Chapter.
Some matters to be taken into consideration in the value of the various classes of assets are given below:

i) Fixed Assets:

When the realisable value of the assets is not required to be ascertained separately by an expert, it has to be seen that book value is arrived at after charging adequate depreciation consistently. Any capital improvements in the past which have been charged off to revenue, should also be taken into account. In the case of land and buildings, the nature of tenancy, whether freehold or leasehold has to be taken into account. The unexpired period of a lease may have a great bearing upon the value of leasehold property.

In taking the value of plant and machinery, the factor of obsolescence due to technological improvements, changes in design, etc. should be given due consideration. If due to technical improvement, the present machinery is found to be outdated, then the value which the plant and machinery would fetch, if sold piece-meal, should alone be taken account of.
ii) Investments:

Shares and securities which are regularly traded in a stock exchange may be valued on the basis of the prices quoted there at. It must, however, be seen that there is regular trading in those scripts, as an isolated transaction may lead to false results. In case of unquoted shares etc., if the amount is material, a secondary valuation of such shares may be necessary; but if the number and value of unquoted shares are not substantial, the value ascertained on the basis of such evidence as is available in the last annual accounts of the company concerned may be accepted.

iii) Stock-in-trade:

Due allowance should be made for any obsolete, unusable or unmarketable stocks held by the company. The stock of finished goods may generally be taken at its market value whereas other stocks such as raw-materials, stores and spare parts, stock-in-process etc., may be taken at their cost. In case there are material amounts of work-in-progress, it will have to be judged on the merits of each case whether only cost should be taken or any element of profit should also be included in their value. It may generally be said that the main consideration in such a case will be the extent of completion and its sale potential even in an
unfinished stage. If it is nearing completion, then a profit element calculated on a conservative basis may be taken.

iv) Sundry Debtors:

Appropriate allowance should be made for any bad debts and debts which are doubtful of recovery.

v) Development Expenses:

These arise:

a) in the case of a new company, when it is in the process of executing its project; and

b) in the case of an old company, when either there is an expansion of the existing production lines or diversification with a view to entering new lines.

It may not be advisable to take the entire expenditure under this head into account. But that part of the expenditure incurred in bringing the project to completion should be taken into account, for example expenses like travelling, hotel charges of the technicians (both foreign and Indian) engaged in erection work.
ASCERTAINMENT OF LIABILITIES:

The amount of liabilities as shown in the books of companies may generally be accepted after proper scrutiny. Due consideration should, however, be given to any contingent liabilities or capital commitments not provided for and any short provisions for expenses etc.

Where liabilities for taxation and dividends are to be met out of any reserves, the appropriate amounts should be included in the liabilities for this purpose. In case the company has made any specific reserves to meet any future losses such as a contingency reserve or an investment reserve, it should be considered whether they really are in the nature of reserves or provisions. If there is a definite reason to regard them as provisions, they should either be included in liabilities or deducted from the relative assets.

The dues of preference shareholders have also to be included with the liabilities. These rights can be ascertained from the terms of issue. Arrears of dividend should be included in the liabilities to the full extent if the shares carry a preferential right to dividends in the event of liquidation of the
company. Where such shareholders have also a right to participate in the surplus, the applicable amounts of such surplus should be included as liabilities together with the paid-up value of such shares.

**FIXATION OF THE VALUE OF DIFFERENT TYPES OF EQUITY SHARES:**

When one type of equity shares has been issued, it creates no problem and the amount of net surplus has to be divided among them equally. If there are different types of ordinary shares, having different paid-up values, but with other equal rights, then the total surplus may be divided among them in proportion to their paid-up values provided that the company has no intention of calling up further capital in the foreseeable future, nor is there any possibility of the company being obliged to make such a call. For example, if fully paid up shares of Rs. 10/- are worth Rs. 17/- then, partly paid-up shares of the face value of Rs. 10/-, where Rs. 5/- have been paid will be Rs. 8.50. Where, however, the difference between two classes of equity shares is only due to one class being fully paid-up and another being partly paid-up and the company expects to call up the further capital in the immediate future, the difference in the value of the two classes of
equity shares should be equal to the amount not called up. In this situation the value of the share will not be proportionate to the amounts paid-up. For example, if fully paid up shares of Rs.10/- are worth Rs.17/-, then, partly paid-up shares of the face value of Rs.10/-, where Rs.5/- have been paid up will be worth Rs.12/-. In case the rights of different types of equity shareholders are different, assigning the surplus to a particular class of shares will depend upon the terms of their issue. For example, if founders' shares have to receive the residue after paying a fixed premium on the other equity shares, then the value of such equity shares will include the maximum of that fixed premium and the remainder will be assigned to the founders' shares.

SPECIAL CONSIDERATIONS IN CASES OF LIQUIDATION:

Where the business of the company is being liquidated, its assets have to be valued as if they were individually sold and not on a going concern basis. In such cases, the total realisable value will often be less than that on the basis of a going concern. When the company itself is in liquidation, but its business is being continued, then this consideration does not apply, but a special provision has to be made for cost
of liquidation. In other words, if the company is itself in liquidation and its business is also being liquidated, the assets will be valued on a liquidation basis and in addition thereto, a provision will have to be made for cost of liquidation. Regard should also be had to the tax consequences of liquidation. If fixed assets are to be sold at a price in excess of cost, the capital gains tax and withdrawal of depreciation allowed in the past should be taken into account.

OTHER PURPOSES FOR WHICH ASSETS BASIS IS APPROPRIATE:

Apart from the specific provisions of the various tax laws, it may be appropriate to value shares on assets basis under many other circumstances, the more important of which are mentioned below:

1. In cases where there is paucity of information about profits that would serve as a basis of valuing shares, such as:

   a) In case of new companies whose accounts do not serve as a guide to future profits.

   b) Where the company has been trading at a loss and there are no prospects of earning any
profit in the near future. The compensation paid to various air-lines companies which were nationalized was fixed on the basis of valuation of their assets since most of the companies had incurred heavy losses in past years.

In Dean v. Price and others (1954) 1 All E.R. 749) it was observed:

"In the case of private company carrying on a profitable business, it is no doubt true that a sound and obvious basis of calculation would be in accordance with the expectation of profit for the future, particularly when the shares in question constitute a majority holding. In my judgement, however Mr. Jenkinson rightly rejected any such basis of valuation in the present case; for a continued expectation of loss would produce necessarily a negative result - A calculation on the basis of profits (that is upon the basis of expected returns on the footing of the company continuing as a going concern) being out of the way, Mr. Jenkinson, I think, turned clearly to a break-up value as on a forced sale as the only available alternative."
c) In case of companies where there is no reliable evidence of future profits due to -
   
   i) violent fluctuations in the business.
   ii) disruption of business.

2. Other Circumstances such as:
   
   a) Where the assets are mostly of a liquid character and can be easily realised as in the case of companies holding shares listed on a stock exchange.
   
   b) When it is intended to liquidate the company and to realise the assets and distribute the net proceeds among shareholders.
   
   c) To ascertain the value of shares for certain statutory authorities, for example for the Reserve Bank of India under the Non-Banking-Non-Financial (Reserve Bank) Directions 1966, etc.

METHODS OF VALUING GOODWILL:

Goodwill is an important intangible asset of a business enterprise but it is difficult to give a precise definition to it. In fact, it is an aggregation of many factors and advantages some of which
may be present in one particular business while others may not. In its simplest form, goodwill may be defined as the capacity of a business to earn in excess of a fair net return. It includes every advantage connected with location, premises, reputation, personality, name, labour relations, etc. It is hard to build, but easy to destroy.

It must be appreciated that goodwill as a recognisable asset arises only when there is a possibility of its transfer.

Goodwill generally does not appear in the accounts of a company except where the company paid for it when purchasing a business. Even where there is a value of goodwill in the accounts, such value does not necessarily represent its fair value. Sometimes, cost of advertising - particularly a major advertising campaign - and cost of development and research are considered as equivalent to goodwill. This may perhaps be partly true but it does not give any guide to the fair value of the goodwill of the business.

METHODS OF VALUATION:

Various methods have been and are being used to assess the value of goodwill. These methods may be
basically divided into two categories, rule-of-thumb methods and scientific methods.

1) A number of years' Purchase of Past Average Profit:

This method has had a very wide application because of its simplicity and general applicability to small business enterprises. In this method, the seller and the buyer agree to take an average of the past profits of a particular number of years and such average is multiplied by another number of years which is also mutually agreed upon. It is considered that the total additional advantage of the establishment and performance of the business in the past is confined to the amount thus arrived at and therefore it represents a fair value of the goodwill of the business. The multiplier may differ from business to business or from individual to individual and no scientific basis is followed for its determination. This method does not take into consideration either the funds invested in the business or a fair return thereon.

2) A number of years' Purchase of the Gross Earnings:

This method is similar to the above method except that instead of applying the multiplier to the average
profits, it is applied to the average gross earnings or sales of the business. This method has received wide acceptance in the valuation of business which depend mainly upon the personal skill of the seller, such as professional practices.

d) A Number of Years' Purchase of Super Profits:

This method is a combination of a rule-of-thumb method and the scientific method of valuation on the basis of super profits. In this method, the super profits are ascertained in the same way as in the methods to be described later on; but instead of being capitalised, they are multiplied by a number of years and the resultant is considered to be the goodwill of the business. In this method, it is presumed that the super profits which are being earned by the business due to efficiency or reputation etc., of the present owner or management will last only for a number of years and at their end, would have been replaced by those earned by the efforts of the buyer or the new management. Therefore, even though the super profits may continue to be earned for a long time, it cannot be said that they are earned for all time to come due to the goodwill at the time of the purchase.
In some cases, super profits are divided into two or more parts and different multipliers are used for each of them. Lower multipliers are taken for the higher levels of super profits.

4) Capitalisation of Super Profits:

In this method, super profits are capitalised and such capitalised value is considered to be the goodwill of the business. The rate of capitalisation is either the same as used in the maintainable profits basis of valuation or may be higher than that.

Super profits are estimated by deducting the net fair earnings of the business from the maintainable profits arrived at in the same way as in the case of maintainable profits basis. Net fair earnings are the earnings which would be attributable to that business if it earned profits at a normal rate. This calculation will, therefore, involve determination of the investments made in the business and the normal rate of return. The investment for this purpose may be considered as equal to the value of the tangible assets and specific intangible assets of a business valued on a going concern basis. The normal rate of return will be equivalent to the earnings rate used for capitalisation in the
maintainable profits basis of valuation. Normal profits are sometimes also called profits on tangible assets, while super profits as profits on intangible assets.

If the rate of capitalisation of super profits is to be the same as the earnings rate, then the total value of the business will be equivalent to that arrived at on the maintainable profits basis. Value of goodwill may therefore be arrived at either by capitalising the super profits or by deducting the value of the tangible assets and specific intangible assets from the total value of the business. If, however, a different - generally higher - rate is taken for super profits, then this value will also be different. Taking a higher rate of capitalisation is justified on the ground that in an established business, it is more certain to earn a normal profit than to earn any profits in excess of the normal. This added uncertainty is reflected in the higher rate of capitalisation (i.e. a lower multiplier) taken for super profits.

In some cases, super profits are divided into two or more parts and different rates are used for capitalising them. In fact, the justification for this
method is an extension of the argument mentioned in the preceding paragraph. When it is assumed that earning super profits is more uncertain than earning normal profit, then it must also be accepted that higher levels of super profits will be still more uncertain to be earned.

5) Discounted Value of Super Profits:

In this method, instead of capitalising super profits they are discounted to their present worth by using the earnings rate as discounting rate. For this purpose, it has first to be established as to how long a period is to be covered and what would be the super profits during that period. Taking super profits only for a limited period is justified on the same ground as for a number of years' purchase of super profits. In fact, this method is an improvement upon the number of years' purchase of super profits method; instead of taking the total super profits for a particular period, it takes the present worth of such super profits.
VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

RELEVANT PROVISIONS OF WEALTH TAX ACT (As amended by Direct Taxes Amendment Act 1989)

1990
PART - III

VALUATION OF PREFERENCE SHARES

PREFERENCE SHARES:

The two dominant characteristics of a preference share are that it has a preference regarding both the dividend and capital. Besides these, a preference share may have other benefits also; but they are not obligatory and depend on the terms of issue and provisions in the Memorandum and Articles of Association of the company concerned.

Because of the limit placed on the dividend which may be paid on a preference share and the additional security provided for the payment of such dividend and of capital, the considerations applicable for the valuation of equity shares are not wholly applicable to the valuation of preference shares.

Consideration should first be given to the rate of capitalisation. As will be readily seen, the risk involved in the investment in preference shares is considerably less than that in equity shares. It follows, therefore, that the expected rate of return on preference shares is also lower with the consequent
effect upon the rate of capitalisation. It frequently happens that owing to the attraction of equity investment as a hedge against inflation many a company's equity share yields a lower yield on the stock exchange than the same company's preference share. The theoretical considerations mentioned earlier therefore do not always apply.

The rate of capitalisation will depend not only on the percentage of dividend but also on the other benefits attached to the preference shares. Some of these additional benefits which a preference share may carry and their effect on the rate of capitalisation and other aspects of valuation are stated below:

1) Preference shares may be cumulative preference shares. In such cases, the risk involved is still lower, with the corresponding effect on the rate of capitalisation. In case, where there is uncertainty of future dividends, this is an important right and a preference share not carrying this right will be valued at a substantially lower figure.

2) The preference share may be a participating preference share. In such a case, it partakes of the characteristics of equity shares and therefore
the rate of capitalisation in respect of the additional dividend which may be paid will not be the same as for the fixed dividend. If this additional payment is unrestricted, then the rate of capitalisation in respect thereof may be taken as equal to the rate of capitalisation for equity shares. If there are restrictions on the quantum of such additional dividends, then the rate of capitalisation will be somewhere between the rate of capitalisation for the fixed dividend and that for equity shares, depending upon the exact terms of issue. It may also be mentioned here that the possibility of the payment of additional dividend in future will be determined when calculating the maintainable future profits and the payout ratio of the company, and on the terms of the payment of such additional dividend. If it is found that the payment of such additional dividend is not expected to be a regular feature, then it would be more appropriate to take the present worth of such additional dividend which is expected to be paid in future from time to time.

3) A preference share may be redeemable. This aspect becomes important in two circumstances:
i) When the date of redemption is not very far;

ii) When the shareholders are also entitled to receive a premium on redemption.

In case the date of redemption is not very far, it would be appropriate to estimate all future receipts in respect of dividends as well as capital and to reduce them to their present worth. In case of premium also the best way is to determine its present worth, although, it may be very difficult to do so in cases where the date of redemption is not certain. Realisable value of the assets of the company may also provide a guide in this matter.

4) The preference share may also carry a right to share in the residual value in the event of winding up. In such cases, a definite value may be placed for this right only when it is known that the winding up is imminent. In other cases, some value may be placed on the basis of the realisable value of the company's assets.

5) A preference share may have a right of conversion into equity shares. The additional value to be placed will depend upon the exact terms of the
right to convert. For example, if the preference shares have a right to convert into equity shares after the expiry of a certain period, then the preference dividends up to such time may be reduced to their present worth and from that time onwards the value may be taken on the same basis as for equity shares and that value should also be reduced to its present worth. The total of these two values will give the value of the preference shares. The price at which the conversion can be effected is also relevant. The price of the preference share will in such a case vary as the price of the equity share rises above the option price.

6) In certain circumstances, preference shares also carry voting rights. In case of private companies which are not subsidiaries of public companies there is no legal provision to regulate such rights and they depend on the Memorandum and Articles of the company concerned. In case of public companies and their private subsidiaries, preference shareholders have voting rights in respect of resolutions which directly affect their rights and also in respect of resolution when
dividends on such shares remains unpaid for certain periods as specified in law. The preference shares currently carrying unrestricted voting rights become very important where the control of the company is sought to be transferred. If the company has divisible profits but has not been declaring any dividend then also such right becomes important in as much as the preference shareholders may force the company to declare dividend on their shares. Any additional value in respect of this right should, however, be considered after taking into consideration the circumstances of each individual company.

Apart from the rate of capitalisation, consideration has also to be given to the margin between the divisible profits and the amount required to pay the preference dividend as also to the adequacy of asset backing for the shares. These considerations become important in extreme cases or where there are additional benefits attached to the preference shares as discussed in the foregoing paragraphs.

Interesting problems arise in the valuation of preference shares with substantial arrears of cumulative dividends. If the company has reached a profit earning
stage the value of the arrears of dividend should be added to the value of the share. The value of the arrears is determined by ascertaining the present value of a series of annuities discounted at an appropriate rate.

Apart from the special considerations mentioned above the value of a preference share is equal to that fraction of its face value as is arrived at by dividing the actual rate of dividend by the normal expected rate of capitalisation.
VALUATION OF SHARES

THE THESIS
SUBMITTED TO THE
M.S. UNIVERSITY OF BARODA
FOR THE AWARD OF THE DEGREE OF
DOCTOR OF PHILOSOPHY
IN
ACCOUNTS

By /
JAYANTILAL H. SHAH
B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL
PROFESSOR OF ACCOUNTS
M.S. UNIVERSITY OF BARODA

BARODA

ANNEXURES: IV

PART - IV : SPECIAL CONSIDERATIONS

1990
PART - IV

SPECIAL CONSIDERATIONS

While valuing shares, a number of situations may arise in which special consideration has to be given to one factor or the other. It will be futile to make an exhaustive list of such factors and only a few of them are discussed below:

1. Controlling Interest:

When a parcel of shares carrying controlling interest in a company is to be valued, some special consideration has to be given to this factor. This special consideration flows from the fact that the purchaser of such a parcel of shares does not acquire only the shares of the company but also control of that company which in itself is a valuable commodity. He has, therefore, to pay for this control also. In Murdoch's case Mr. Justice Williams said, "It is evident that a parcel of shares sufficient to carry special resolution may have higher value than parcels which are insufficient for that purpose." In British Columbia Power Corporation Ltd. v. Attorney general of British Columbia, Chief Justice Lett admitted that

the normal course would be to arrive at a fair market value by a process which would not take account of the value of control and then to add to it an allowance as the value of control. The special value for control is allowed as an inducement to dislodge the existing owners and as a price for the advantages to the purchaser of an existing business in entering into a new territory or the elimination of competition. But because of special circumstances of this particular case the judge did not allow a special value for control.

Normally, controlling interest is involved where the shares to be valued constitute more than 50% of the equity shares of a company. If they constitute a larger proportion which is in excess of 75% of total equity shares, then the value of the control increases further because additional advantages like alteration of the Articles or the objects clause of the Memorandum or taking the company into liquidation etc., are also acquired by the purchaser. In some cases where the proportion of shares acquired is less than 50% but because of the special circumstances of the company, such as (__) has a very widely scattered shareholding, the control of the company might still pass to the purchaser. In such circumstances, it has to be judged
on individual circumstances whether the value of control or a fraction of such value should be included in the value of that parcel of shares. There may also be cases where even the majority of equity shares may not be in effective control or may be in the danger of losing such control; for example, existence of convertible debentures, existence of Government loan which may be converted into equity shares under S.81(4) of the Companies Act, 1956, etc. In such cases the controlling interest will lose some of its value.

Controlling interest normally gives the right to appoint at least a majority of the directors and to have the effective management of the company, besides advantages like taking a decision to expand the business or sell the business. The value of the control, therefore, has to be based on an analysis of these advantages. The seller in such cases parts not only with the shares of the company but also with its control and therefore has to be compensated for a loss of employment and/or earning capacity.

From an analysis of the advantages, it may be observed that they may be converted into monetary equivalent only when it is known as to how much additional earning they might provide to the purchaser. The valuer
will have to study many aspects and give due considerations to them. Some of these aspects are mentioned below:

i) If the existing business of the company is not being run with maximum efficiency, then it may be assumed that any additional profits which may accrue because of better management will be derived by the purchaser.

ii) If the company has surplus funds which are not invested properly, it may be assumed that the purchaser will earn additional profit by investing them in a prudent way.

iii) If it is possible to increase profit by changing the product-mix or by concentrating on a particular line of business or by a reasonable expansion, then also the additional profit to be obtained from any of these circumstances has to be taken into account.

iv) The valuation of the business has to be made in such a way as to ensure that all the intangible assets of the company are given due recognition. These will include goodwill, patents, trade marks, copyrights, secret
formulas, expenditure on research and development and on advertisement etc.

In many cases, it will be found that a particular purchaser will also get some additional advantages because of his own individual circumstances as for example, when he can earn additional profits by combining the business of the company to be acquired with his existing business or by avoiding competition to his existing business. In such cases, such a purchaser will perhaps be prepared to pay a higher amount than any other purchaser. For the purpose of arriving at a fair value, however, such extraneous factors should not be taken into account. The additional value to an individual purchaser should instead be considered as a premium over the fair value which that particular purchaser may be willing to pay.

While the above theoretical considerations are relevant the value of a controlling block of shares can be substantially depressed if the amount required to be invested runs into several lacs of rupees. The very magnitude of the transaction will depress their value because the number of persons likely to be interested in paying substantial amounts of money is very limited.
2) Restrictions on Transfers:

Easy marketability is one of the factors to be considered in valuation of shares. Though public companies are required not to place any restrictions on such transfers, in many of them shares are closely held which prevents their free transferability, again in a number of cases shares are not listed on the Stock Exchanges, to ensure easy marketability. Private Companies by their very definition, are required to restrict the transfer of their shares. Such restrictions may vary much in their scope of transfer, to a pre-emptive power of the existing shareholders to acquire the shares of a member desirous of selling them, at a stated price.

Section III of the Companies Act, 1956, permits an appeal to be made to the Central Government if a company refuses to register a transfer.

Restrictions on transfer of shares generally have a depressing effect on their fair value in as much as the ready market for sale is restricted. The extent of the decline in value depends upon the severity of the restrictions. A general power of the Board of a public company to refuse registration of a transfer may
not have much effect; but the pre-emptive right to buy shares at a price stated in the Article of a private company may keep the value of shares limited to such price.

The following cases illustrate the effect of restricting the free transferability of shares:

a) Salvesen's case: A reduction of 24 per cent of the market value per share was made on account of the restrictions imposed on the transfer of shares. In this case there was a somewhat unusual and stringent clause that any holder of less than 10% of equity shares could be compelled to transfer them at any time.

b) In Crossman's case, an addition of about 1½% to the yield rate was made by Lord Plender (whose evidence was accepted) to allow for both non-marketability and the depreciatory effect of the several restrictions on transfer present in the articles of association of the company. The restriction was that shares had first to be offered to their existing shareholders at a price fixed under a formula laid down in the articles.

c) In Fryer's and Murdoch's cases where the blocks of shares subject to valuation carried 75% of equity shares and consequently enabled the holders to pass a Special resolution to alter the articles of association containing the restrictions on transfer, such restrictions were held not to depress the value of shares.

d) A discordant note has also been struck in the case of Abrahams v. Federal Commissioner of Taxation. Mr. Justice Williams stated with regard to the restrictive clauses in the articles of association that a share in a partnership would have the same disadvantages, but, it had never been suggested that such a share should be discounted on this account. To a prudent purchaser willing to give full value for the shares, this restriction should not have any errors. But this case should not be considered as establishing a new principle.

3. 70 C.L.R. 23.
3) Capital Structure:

The capital structure of a company may in some cases have some effect upon the value of its shares. When the ratio of equity share-capital to the total capital is unduly low, the value of the equity shares will be depressed as the element of risk involved in such shares will be high. The operating profits of the company have to be applied first to pay interest on borrowed funds and dividends on preference capital and only the remainder is attributable to the equity capital. If borrowings and preference capital are very large as compared with the equity capital, a large proportion of profits is used in meeting their claims and only a small amount is left for the equity capital. Because of the smallness of the equity capital in such cases, even a small left-over surplus might give a fair return thereon. But this return will be greatly affected by fluctuations in profit and even a slight variation in the total profits may increase or reduce the rate of equity dividend to a great extent.

Unduly small equity ratio is often the result of over-trading. This factor in itself places a limit on the prospects of the company and therefore has a direct effect on the value of its shares.
4) Accruing Dividends:

In the normal process of valuation of shares, no account is taken of accruing dividends. If, however, a long time has elapsed since the declaration of the last dividend and the rate of dividend usually declared by the company is substantial, then the present worth of the proportionate dividend expected to be declared by the company may be added to the value of its shares. The proportion to be so added will naturally relate to the period from the last declaration up to the date of valuation. Expected dividend may be calculated on the basis of expected profits and pay-out calculated for other purposes of valuation.
VALUATION OF SHARES

THE THESIS

SUBMITTED TO THE

M.S. UNIVERSITY OF BARODA

FOR THE AWARD OF THE DEGREE OF

DOCTOR OF PHILOSOPHY

IN

ACCOUNTS

By

JAYANTILAL H. SHAH

B.Com., Grad. C.W.A., F.C.A.

UNDER THE SUPERVISION OF

PROF. A.G. PATEL

PROFESSOR OF ACCOUNTS

M.S. UNIVERSITY OF BARODA

BARODA

ANNEXURES: V

SCHEDULE II – RULES FOR DETERMINING THE VALUE OF SHARES

1990
ANNEXURE — V

SCHEDULE II
(See section 8(a))

RULES FOR DETERMINING THE VALUE OF ASSETS

The value of any asset other than cash, for the purposes of this Act, shall be determined in accordance with the provisions of Schedule III to the Wealth Tax Act, which shall apply subject to the following modifications, namely —

In the said Schedule —

a) the reference to "valuation date", wherever it occurs, shall be construed as a reference to "date of death";

b) for the word "assessee", wherever it occurs (except in rule 16, the word "deceased" shall be substituted, and such other consequential amendments as the rules of grammar may require, may also be made;

c) reference to "wealth-tax", wherever it occurs, shall be construed as a reference to "wealth (inheritance) duty";
d) in rule 3, the reference to section 7 of the Wealth-tax Act shall be construed as a reference to section 8 of this Act;

e) in sub-item (iii) of item (a) of sub-rule (2) of rule 14, for the words "previous year relevant to the corresponding assessment year", the words "previous year ending on the date of death" shall be substituted;

f) in rule 16, the reference to section 5 shall be construed as a reference to section 5 of the Wealth-tax Act;

g) rule 17 and rule 19 shall be omitted;

h) in rule 18 and in sub-rule (2) of rule 20, reference to section 16A of the Wealth-tax Act shall be construed as a reference to section 22 of this Act.