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

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HISTORICAL BACKGROUND OF CONCEPT OF VALUE.

1990
CHAPTER I

HISTORICAL BACKGROUND OF CONCEPT OF VALUE

01. VALUE, CONCEPTUAL DEVELOPMENT

01.01 How old is the theory of value? One may say as old as the history of literature, at least. But, strangely, 4000 years were to pass between Abraham's purchase of Machpelah's field (Abraham purchased from Hittel Ephoram field in 2000 BC) \(^1\) and Adam Smith's publication of *The Wealth of Nations* \(^2\) (generally acknowledged in West as the first serious economics text) in 1776. Since Smith, a veritable explosion of economic theory has moulded, twisted, and refined the theory of value into a shape and form that would amaze the absent-minded Professor Smith and baffle the patriarch Abraham.

01.02 Men have bartered since the Stone Age, and international trade dates back to the ancient empires of EGYPT, CATHAY and INDUS civilization. A question, then, naturally arises: Why was value theory neglected so long? Or, asked another way: What happened in the 18th century that caused philosophers and scholars suddenly to turn their attention to economic thought?

2. *The Wealth of Nations* - by Adam Smith
An understanding of those forces and their development, contemporaneously with the development of economic theory, should help appraisers understand the economic framework in which they practice, as we enter the third century of modern economic thought.

02 OBJECTIVE CONCEPT OF VALUE

02.01 As for value, SMITH held an objective concept. He thought that value consists of the cost of production, which is comprised of three elements: land, labour and capital. Smith didn't say much about it, but his concept of profit also included the element of incentive to the entrepreneur, or co-ordinator, who combined the other three elements to produce wealth. We now recognize these as the four agents in production: LAND, LABOUR, CAPITAL and CO-ORDINATION.

02.02 Value is created - wealth is created - when all four agents are brought together to create or produce something useful and desirable. This theory is called the COST OF PRODUCTION THEORY; i.e., value is based on the cost of production. Smith brought us to the concept on which our present COST APPROACH to value is largely based: namely, that value is objective; value is in the object. Nevertheless, it is not an absolute value as the ancient people said; it is not
a moral value as the philosophers of the Middle Ages said. IT IS A VALUE BASED ON THE COST OF BRINGING AN OBJECT INTO BEING.

02.03 The four (three) agents of production were first mentioned by Smith, and they formed a great deal of the foundation of our modern theory of economics, even of appraising. Each of these agents has a return connected with it. We call the return to land RENT, the return to labour WAGES, the return to capital INTEREST and the return to coordination PROFIT. Smith's primitive concept is the basis for the appraising. Smith's value of an asset was sum total of rent, wages, interest, and profit.

02.04 Malthus also wrote about value and emphasized scarcity. He observed that, as the population grows, land gets scarce. He also said that value would go up as better lands would become more scarce. As better lands get scarce, a premium will have to be paid for the rent on those lands, and that means the price of food will have to be raised. As the price of food is raised, the price of land will go up, in an endless cycle. That disturbed Malthus greatly because he felt that if price of food went up, wages would have to go up, and if wages went up profits would disappear and so would jobs. This is called MALTHUS' IRON LAW OF WAGES.
Malthus and Ricardo did a great deal to discredit the natural law theory of economics. Into this rapidly festering situation strode two men who were to have a great influence on the future - in the case of one, an incalculable influence that would rock the world, and still is rocking it: KARL MARX. The communist Manifesto laid the early groundwork for the Bolshevik Revolution and the world-wide Communist empire that followed. But the same year his paper was published (1848), another much more moderate book, PRINCIPLES OF POLITICAL ECONOMY, was published by JOHN STUART MILL. It replaced The Wealth of Nations by Adam Smith¹ as the most widely-read treatise on economics for the next 50 years or so.

Marx believed that all value is derived from Labour. Capital after all, is only stored-up labour and land, he said, should belong to all. Because all value, then is derived from the workers, all wealth should be owned by the workers.

MARX Vs MILL

Marx emphasized the principles of social determination and human involvement in value. On the other hand to Smith economic man was an animal,
means of production. Smith's man would work for a return. This concept still underlines much of present date "Classical Economics". Marx went to other extreme. He believed that as it is the worker who produce it, value should rest in him. In his opinion there was no importance of co-ordination by intellect and prudent employment of capital (saving the workers from their toil). However, both Mill and Marx agreed that if cost of labour goes up, profit must come down. Marx wanted cost of labour to go up to wipe out the entire profit. But neither of them foresaw that both cost of labour and profit may go up.

04 AUSTRIAN SCHOOL

04.01 In the last part of 19th Century this school came into being. It rejected the idea of class struggle by Marx. They said cost affects value only as it affects supply, and the value of an item is not necessarily it's cost. Rather, the value of an item is set by its margin of utility.

04.02 The Austrian School (which included some Germans, Austrians, Americans and Englishmen) first explained the idea of marginal utility; i.e. the cost of last unit added; sets the value of all the units.
NEOCLASSICAL SCHOOL

05.01 After this school; came the Neoclassical (New Classical) School. Alfred Marshall was the chief spokesman for this group, which went back to Smith, Ricardo and Mill. He tried to refine their teachings, applying them under more modern conditions. The Neoclassical School improved our understanding of the effect on value of supply and demand. They believed that the supply and demand are related to scarcity and utility.

05.02 One contribution of the Neoclassical School to appraisal science needs to be emphasized. In these days, when the cost approach to value is under heavy philosophical cross-examination, we would do well to remember the observation of the Marshallians: "cost of supply, in the long run, has a greater effect on price (Value) than demand; demand, in the shortview, usually exerts a greater force than cost." The price (value) of goods has climbed steadily and rapidly during the last decade because of steadily increasing cost. Demand may sputter and fume and occasionally hold the line, but eventually it falls back in retreat.
06 CYCLICAL NATURE OF BUSINESS

06.01 The Neoclassical School, which came into existence around the turn of the century, emphasized the cyclical nature of business activity. Business activity could be divided into short, medium, and long-term trends. Today, we are taught to analyze business in terms of these trends and even to compute mathematical formulae which best fit or describe historic trends. Some economists believe that future business cycles can be predicted by projection of past trends and thus their impact on price and value.

07 KEYNESIAN DOCTRINE

07.01 A predominant doctrine that arose from this school is the one known as the Keynesian Doctrine, which is debated even today. In a few words, the Keynesian Doctrine involves spending by the government in times of recession in order to keep the economy in relative balance. When the average prudent individual is low on money and going into debt, he usually cuts back on spending. Many taxpayers think that when the government is in the same condition it ought to behave similarly. Dr. John Maynard Keynes, who has had tremendous influence on modern political and economic
thought, believed the opposite. He felt that depre-
sions were aggravated by underspending and over-
saving and would continue indefinitely if the govern-
ment did not "prime the pump" with deficit spending
to cause expansion in the economy.

08 HISTORICAL AND INSTITUTIONAL SCHOOL

08.01 The Historical and Institutional Schools also
have influenced the theory of value. As the name
implies, the Historical School emphasized the study
of history for a better understanding of economics –
not economic history alone but all facets of history,
including politics, human behaviour and technological
advances. "Learn the facts and they will tell their
own story," argued the Historical School. "Not so,"
said the Institutionalists. "The facts must be
analyzed carefully in the light of a constantly
changing milieu."

08.02 The Institutional School emphasized the study
of economics in terms of contemporary human behaviour
and business organization. The son of Norwegian
immigrant, Thorsten Veblen, was a leader in this school.
His most disturbing book was The Theory of the Leisure
Class, in which he critically examined the emergence of

1. The Theory of the Leisure Class - by Thorsten Veblen.
a large class of people - beneficiaries of the capitalist system - who made no real contribution to human progress. John Kenneth Galbraith's *The Affluent Society*¹ is a contemporary example of the institutional approach.

## 09 PRESENT STATUS OF ECONOMIC THOUGHT ON VALUE

### 09.01 We have seen how individuals have wielded a mighty influence on the theory of value in the past as they wrestled with political and economic problems of their day. But what about the present? What are economic pundits saying today that will affect our understanding of value tomorrow? Only time can answer this question. But this generation has its own problems, and the solutions developed to meet them will provide the sequel to this story. Here are some of the most baffling challenges to the Smiths and Ricardos of the 2000.

### 09.02 Ecology:

What is the market value of clean air, pure water, and unspoiled forests? How can the invisible hand of the marketplace be reconciled with the very visible need of environmental protection?

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¹ *The Affluent Society* - by John Kenneth Galbraith.
09.03 Inflation:

What is the effect on present value of unchecked, accelerating inflation? How can future benefits be measured for present worth when the yardstick is of constantly changing length?

09.04 Population:

If the population continues to grow, disaster is inevitable, said Malthus. Before you laugh, look at India and China. If population stops growing, markets will stop growing. Capitalism, it is agreed generally, needs economic growth to remain healthy. If zero population growth reaches its goal, will economic senility set in?

09.05 Imbalance:

The economic imbalance of have and have not nations are too well known to be emphasised. What is the effect of human sufferings man made and nature? Should the same be considered in theory of value?

09.06 Corporate Domination:

Increasingly, the productive power and wealth of the nation are concentrated in a few large corporations and financial institutions both in private and
public sector. This has been made possible by the mixed enterprise system. By and large, the consumer has gained from fierce competition among the corporate giants. But it has become painfully clear that many of the corporate giants can now administer prices, rather than allow them to be set by the free market. As these giants move into different fields, which they now are doing in giant steps, new problems will be raised for appraisers. When a corporate giant enters one field in a big way, it would dictate the terms. It will affect market value when it enters the field. In the same way, when the capital giants withdraw their funds from the market, it will also affect the market value in terms of cash or its equivalent. The only equivalent of cash is cash.

09.07 Government Domination:

Once a big government gets the taste of control, it seldom loses its appetite. To mix metaphors, many businessmen have invited the government to dance, only to find themselves in a death-grip when the music stopped. On the basis of many worthwhile objectives — such as MRTP Act, Urban Land Ceiling and Regulation Act, Essential Commodities Act, Regulation of Utilities, Public Sector Undertakings and Defence Industries,
the government at all levels has entwined itself increasingly in every phase of business of activity in India. Perhaps one of the more dangerous areas of government involvement is planning. Planners like their plans to work. When they don't work by natural forces of supply and demand or cause and effect, the terrible temptation to holders of power is to make them work. The free market-oriented discipline of the appraiser is hard-pressed to accommodate itself to such an administered market. In recent years, we are forced to redefine market value in order to achieve the social ends (of, at times, doubtful utility and effect) contemplated and liked by the legislators.

10 SUMMARY

10.01 Contemporary appraisers work with a concept of value that is still maturing after a stormy childhood and confusing adolescence. The colour and fabric of the term have been determined by a curious procession of persons little known outside the "dismal science" of economics. Philosophers, persons, revolutionaries, scholars - all struggling to find solution to the riddle of life surrounding them - have passed us the baton in a never-ending race for the truth. Each of them had a notion, a theory, or a
prophecy, born of his concern for the quality of life in his own particular milieu. None of them was entirely correct; none entirely wrong. The virtue of each was that he observed, inquired, researched, and recorded faithfully his conclusions. He was faithful to the truth as he saw it.

10.02 This treatise is an attempt in this direction; limited to appraising of shares in a company for fiscal purposes; an attempt to add one drop to the vast ocean of knowledge. It draws heavily and without any hesitation from the available reservoir. If it can add to, or refine an iota of it; the attempt made herein would be worth its labour. It joins professional appraisers in discharging their responsibility to continue to search out facts, observe trends, interpret human interactions, and record their judgements with integrity. In a constantly changing world, the slogans of the past must ever be challenged by the realities of the present.