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
CHAPTER III

VALUATION

01.01 The process by which a value of a thing is assessed or determined is commonly described as "Valuation". As to the approach to the valuation process just like content or meaning of the value, there is a great deal of variations and has to be approached according to the purpose for which valuation is to be made.

01.02 ILLUSTRATION

01.02.1 Restricting ourselves to the value in the economic sense the same item of property may be appraised differently for different purposes on different occasions or in different situations. This fact is brought out by beautiful illustration given by James C. Bombright in his book "Valuation of the property" at page 3 - 4 as under:

01.02.2 "An electric light and power company is organised under the laws of one of our forty-eight States, for the purpose of constructing and operating a power plant and distributing system. The cash-cost of the construction is $1,00,00,000 against which the

company issues $1,50,00,000 par value of bonds, preferred stock and common stock.

01.02.3 Several years after the promotion of this enterprise, the State Public Service Commission values the property in order to determine the reasonableness of the rates which are being charged by the Company. The commission finds a value for rate-making purposes of $1,10,00,000 but on appeal the company secures from the United States Supreme Court a holding that 'fair value' of the property is not less than $1,30,00,000.

01.02.4 While the Public Service Commission has been making the above appraisal, a different branch of the Government, the State Board of Tax Assessors, has assessed the property for the purpose of the general property tax. For this purpose, however, the value has been fixed at $80,00,000.

01.02.5 Two or three years later, the public utility runs into financial difficulties with the result that a receiver is appointed. After a delay of many months, a reorganisation takes place by means of foreclosure of the corporate mortgage. At the foreclosure sale the entire property is sold to the reorganisation
committee for the sum of \$50,00,000 which is the upset price fixed by the court as representing the value of the assets.

01.02.6 As soon as the reorganisation committee makes the purchase for \$50,00,000 it transfers the property to a new corporation, receiving in exchange an assortment of stocks and bonds amounting to a total par value of \$1,20,00,000. Before issuing these new securities, the committee is obliged to secure the approval of the Public Service Commission, under the authority to regulate all public utility securities. The approval is given after strenuous opposition on the part of a minority of the commission, who insist that the 'fair value' of the property is clearly less than \$1,20,00,000.

01.02.7 The final chapter in the history of this company is the condemnation of the property by the State, which takes it over as a State-owned enterprise under its power of eminent domain. The price paid by the State is determined by a jury under careful instructions by the trial judge. A figure of \$1,60,00,000 is awarded and the award is confirmed on appeal by a higher Court.
01.02.8 In the above hypothetical illustration, substantially the same property has been given five materially different values for five different legal purposes:

i) Rate making;
ii) Taxation;
iii) Upset price fixation;
iv) Reorganised capitalisation, and
v) Condemnation.

01.02.9 The illustration is hardly exaggerating; the wide discrepancies between values actually placed by judges and administrators upon the same properties for various legal purposes indicates genesis of problem faced by appraisers.

01.03 SEMANTICS: ITS IMPORTANCE

01.03.1 What is to be valued and for what becomes the most important consideration in the process of valuation. Some of the appraisers have considered the valuation of the property in light of the common sense approach. However, before the process of appraisal starts it is important that some of the confusing terminology is clarified and the terms used in the process of appraisal are used to mean...
same thing under different situations or otherwise are so indicated to bring out the correct meaning. This involves importance of semantics in the art of valuation.

01.03.2 To dramatize the importance of semantics, i.e. accurately interpreting reality, when communicating through oral or written appraisal reports, we will have to compare and contrast two traditional word definitions and descriptions with some redefinitions as would interpret reality in today's environment. These traditional words and definitions are taken from Real Estate Appraisal Terminology and are currently used and accepted by many appraisers in their oral and written reports.

01.03.2 VALUE

"The quantity of one thing which can be obtained in exchange for another ....." or "Value is the present worth of future benefits arising out of ownership to typical users or investors."

1) Does not the word thing and present worth imply physical existence?
2) Could not the above words imply that value exists (physically or scientifically in the bricks mortar) ?

3) Is it not more accurate to convey that value is a concept (notion) ?

4) Is it not more accurate to convey the fact that a concept is merely a word label (name for a derived result) ?

01.03.2 MARKET VALUE

"The highest price in terms of money which a property will bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus." (underlined added).

01.03.2 COMMENT

1) What is meant by money ?
2) Are there not many kinds of money ?
3) What is a competitive and open market?  
4) Can any human being ascertain all conditions ?
5) Is it possible for appraisers to interpret these concepts identically?

6) Is it possible to interpret a concept out of context (i.e. without relating the concept to someone's experience or to a physical thing)?

01.04 REALISTIC APPROACH

01.04.1 The following definitions and descriptions are more realistic and accurate in today's reality:

01.04.1 VALUE (A RESULT)

A mental concept used as a label or name to describe a monetary conclusion about property. The word value does not represent an actual object. Consequently, it is not some thing that physically exists. Rather, value is merely a word symbol that people use to denote a monetary conclusion or result. The word has no real significance unless the underlying monetary presumptions (determinates) from which value was derived are clearly understood and accepted.
01.04.2 MARKET VALUE (A RESULT)

A mental concept (similar to the word value) used as a label by people in the business community to specify a particular monetary conclusion or result. The label does not represent a thing that exists. It is merely a name that designates a monetary conclusion to be derived by people in a particular market.

01.05 EFFECT OF REALISTIC DEFINITION

01.05.1 What would be the implications if the above words and terms were accepted by appraisers as true representations on today's reality? The primary effects, would be the following:

1) In lieu of estimating the market value of the subject property - which in reality does not exist - the appraiser first would identify the problem at hand, the specific function for the appraisal report (i.e. what decisions are expected to be made from the report) and the viewpoint from which the decisions are to be made (i.e. owner, purchaser, lender,
investor, condemnor, condemnee, taxgaterer, etc.)

2) In lieu of pretending or idealizing that value is some physical thing that exists, we would acknowledge that value is merely a concept or notion that is applied as a label to potential monetary conclusions (i.e. potential monetary agreement to be derived by human beings with possession of various kinds of money purchasing media).

3) In lieu of asserting that the traditional terms and phrases are an accurate description of reality, we would rather describe our expressions in words than can be visualized or experienced by human beings.

02 WHAT IS TO BE VALUED? - WHETHER A PROPERTY OR INTEREST IN PROPERTY?

02.01 If the above concept of the term value and market value is accepted then the process appraisal is placing monetary label to the interest in property rather than on the property itself. Mere existence of a property do not per say has a value unless an interest therein is specified.
02.02 The term 'Property' is defined in Webster's 'New World Dictionary', as under:

02.02.1 Property: One's own - a) the right to possess, use, and dispose of something; ownership (property in land) (b) something, as a piece of writing, in which copyright or other rights are held
2. a thing or things owned, possessions collectively; esp., land or real estate owned. 3. a specific piece of land or real estate. 4. any trait or attribute proper to thing or, formerly, to a person; characteristic quality; peculiarity; specif., any of the principal characteristics of a substance, esp. as determined by the sense or by its effect on another substance (the properties of a chemical compound).
5. something regarded as being possessed by, or at the disposal of, a person or group of persons (common property). 6. logic, an essential quality common to all members & as species or class. 7. Theatre, Motion Pictures & TV any of the movable article used as part of the setting or in a piece of stage business, except the costumes, back-drops, etc.

Whereas in the same volume, 'Interest' is explained as under:
"Interest": 1. a right for claim to something. 2. a) a share or participation in something (b) a business, etc., in which one participates or has a share. 3. (often pl.) advantage; welfare; benefit. 4. (usually pl.) a group of people having a common concern or dominant power in some industry, occupation, cause, etc., (the steel interests). 5. personal influence. 6. a) a feeling of intentness, concern, or curiosity about something (an interest in politics). (b) the power of causing this feeling (books of interest to children). (c) something causing this feeling (the academic interests in a scholar). 7. importance; consequence (a matter of little interest). 8. (a) money paid for the use of money (b) the rate of each payment, expressed as a percentage per unit of time. 9. an increase or addition over what is owned (to repay kindness with interest) - vt. (prob. M.E. Interessed interessee + ed) 1. to involve the interest, or concern, of; have an effect upon. 2. to cause to interest, or take part in (can I interest you in a game of gold?) 3. to excite the attention or curiosity of - in the interest (or interests) of; for the sake of; in order to promote."

02.03 From above meaning of term 'Property' and "Interest", it would be apparent that for an appraiser,
it would be better that he considers the appraisal process as being the appraising of the interest in the property rather than that of the property itself.

02.04 To illustrate the above concept of appraisal of interest in property rather than the property, we may say that a spacious house located at far distance place like in the centre war ravaged country with no prospect of revival would have little value in terms of interest of use rather than a house with much less luxuries located in the centre of busy metropolitan.

02.05 Similarly a Saint who has renounced the world would have no value for an earthly thing whereas an earthling will have a potential interest in property. Thus, it is the interest in property rather than the property itself that influences value. And the value is as said is a miscal concept.

02.06 Justice Bhagawati J. (then he was) while delivering his judgement in the case of C.W.T. V.P.N. SIKAND. 107 ITR (SC) 1977\(^1\) page 521 said -

"This question cannot be satisfactorily answered, unless we first determine the nature of this asset; what is the interest in property.

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1. C.W.T. V.P.N. Sikan 107 ITR (SC) 1977
qualitative as well as quantitative, which this asset represents!

02.07 Thus value of a property to an appraiser represents in what is the nature of interest which is sought to be appraised. Identification of the interest in property is prelude to the appraisal process.

03 HOW TO IDENTIFY THE INTEREST

03.01 If the above concept is accepted, the process of appraisal becomes as under:

1) Who wants it to be done?
2) Why he wants it to be done?
3) What is the time frame available?
4) What decisions are likely to be taken?
5) Is there any probability of cross verification?
6) Could we challenge the list of interest?
7) What are the interests to be appraised?
8) What interests are left out after the challenge?
9) Appraise the interests left out.
03.02. HOW TO IDENTIFY THE TOTAL INTEREST IN PROPERTY?

Identify main point of appraisal of interest in property.

What is the function (use) for the value conclusion? (Function precedes value)

Who will read and make decisions from the report?

What questions does the reader of the report want answered?

List according to priority

Is solution within my control?

Control implies power to direct

YES NO

1) Few presumptions required.  i.e. facts are available.  1) Adopt appropriate presumptions.
2) Minimum judgement required  2) Much judgement required.
3) Uncertainty is minimal.  3) Be creative.
4) Derive on value conclusion.  4) Derive more than one value conclusion.
04 APPROACH FOR THE APPRAISERS

04.01 In the today's environment the appraisers do agree that time has come to re-examine presumptions (i.e., Rules and Regulations and definitions of appraisal terminology) and derive the new philosophy and bring out the relations between the real valuation and real economic problems for which the appraisal is needed.

04.02 If one agrees that the traditional philosophy does not reflect an actual picture of reality, then it has to be changed. None of the present Rules are irrevocable laws of nature. The basic understanding and knowledge of semantics would change the philosophy of the appraisal process. Before we insert upon the study of share valuation let us for a while, deal with the process of arrival at a value conclusion. This process is outlined in the following diagram and is explained subsequently.
A Dynamic System for Problem-Solving Derive

04.03 KEY CONCEPTS

04.03.1 Viewpoint:

The necessary position (usually an occupational position) from which a conclusion, decision, or judgement is evaluated. Value conclusions must reflect someone's viewpoint - be it a lender, investor, seller, owner, condemnee, or any other decision-maker.
04.03.2 **Judgement**:  
A specific person's induced notions from his personal experiences and observations. Judgement describes and acquires quality or attribute; it is not a thing that is inherent within a human being.

04.03.3 **Presumptions**:  
A future event or conditions that is possible and realistic, but uncertain. This concept often is interchangeable with proposition, theory, hypothesis, or postulate.

04.03.4 **Premise**:  
The foundation upon which conclusion is drawn or deduced. In the valuation process, a premise represents all the adopted presumptions considered appropriate for deriving a conclusion.

04.03.5 **Derive**:  
The process and methodology selected for deducing a conclusion. After a premise is adopted, a mathematical procedure for
expressing and qualifying the premise, must be chosen.

04.03.6 Conclusion:

The necessary consequence of a prior premise. The conclusion is an exact mathematical number, but an uncertain event. A value conclusion is valid if a decision-maker accepts the underlying premise, and invalid if he rejects the underlying premise.

04.03.7 Note:

There is no right or wrong in the above process. Because no human being can accurately forecast future events, any one particular conclusion is always "right" if you accept that person's premise. The question really is: Do you want to accept or reject the premise?

05 APPROACH TO THE APPRAISAL ASSIGNMENT

05.01 It is very important that an appraiser must make an exact definition of the various elements of the appraisal assignment at the onset of any
appraisal proposal and more important when appraisal or valuation of shares is involved. It is sound and very logical that the first step in any assignment would be to define the task on hand. However, as is known to most of the appraisers, in most of the cases initially the definition of assignment is incomplete. The person or a client would not be experienced enough to explain to the appraiser the details that are required to be included in the appraisal assignment or it may be possible that he would not be in a position to visualise or think the implications of some of the aspects of the appraisal. The professional appraiser should give the client guidance in these details. Failure to be through and explicit in the appraisal assignment is one of the main sources for (1) Errors (2) Delays (3) Excess cost (4) mis-understanding between intendant user and the appraiser in any valuation and more specially so in case of business valuation.

05.02 The basic elements of the appraisal assignments are:

1) Definition of the interest or interest to be appraised.
2) The data or data of valuation.
3) The purpose or purposes of appraisal.
4) The form, extent and format of the report.

05.03 The definition of the assignment should satisfy who made the assignment and who accepted the responsibility to take up the assignment.

05.04 The other aspect of planning the assignment is also of a critical importance.

05.05 In cases where it is not possible to define all the elements or relevant details of the appraisal assignments, the appraiser should bear in mind to complete the same as and when the opportunity of doing so arises. Making the list of the elements upon which no personal knowledge is available would help the appraiser to see the important factor he has not overlooked or mis-construed. The first step in defining the interest or interests to be appraised should include the identification of the interest to be appraised.

06 DEFINITION OF INTEREST TO BE APPRAISED

06.01 The appraiser in share valuation assignment should list out the type of shares to be valued.
06.02 The descriptive nature of the shares, numbers of shares included, the details as to the history of transfers included in the said shares would enable him to have basic information on the interest to be appraised.

06.03 Definition of interest relatively:

Apart from the definition of the interest in share in itself, the appraiser should study the shares, vis-à-vis the total number of shares of the type issued, its holding patterns, present listing of the said shares at various stock exchanges if any the near future prospective changes in any of the above information and relative information regarding any effect thereon on the present shares under consideration.

06.04 Any special description attached to the shares being valued must also be a part of the description of interest being valued since any restrictions normally would have negative effect on value of other things being equal.

06.05 There also may be rights which attached to a particular share in question and that may have a
positive effect such as the owner having an option to subscribe to the shares of the company.

06.06 If there is more than one class of shares, then the appraiser assignment should indicate what class of shares is being valued and the proportionate interest or the shares being valued to the total equity capitalisation as well as to their own class of shares.

07 DATA OR DATAS OF VALUATION

07.01 The specific valuation data or datas are critical variables to be determined at the outset. The value will vary from one data to another for various reasons. Some times the valuation even changed fairly drastically within a short time as the result of certain events.

07.02 Sudden and substantial changes in the investors perception of the value of shares of a particular company's shares are demonstrated in stock exchange everyday. There are many Court cases involving tax litigation where significantly different values have been justified within very brief time
spans because of changes in relevant circumstances.  

08 PURPOSE OR PURPOSES OF THE APPRAISAL

08.01 Perhaps the most important point to establish here is that the purpose of the appraisal will have a substantial impact on the methodology used, and therefore possibly on the result, since different methodologies are acceptable for different purposes, there should be nothing incompatible between these different approaches and results.

08.02 For example, as the Harvard Law Review pointed out: Some appraisers and courts tend to assume that accounting valuations of corporations and of stock for other purposes can serve as models for appraisal valuation. Although this may sometimes be true, more often the method should depend on the reason for the valuation.  

08.03 Victor I. Eber, a CPA and former chairman of the Business Management Institute, explains the critical importance of defining the purpose of the appraisal:

1. "See, for example, Morris M. Nessin, 48 T.C. 502 (1967), acq. 1968-1, C.B.2. Even though the company made a public offering at over $36 shortly after a gift of stock, the court upheld a value of $13 for gift tax purposes as of the date of gift.

"Appraisal techniques for income, estate, and gift tax purposes of acquisition, merger, liquidation, divestiture, split-up and spin-offs .... the typical appraisal for commercial purposes will frequently deal with factors of concern to prospective purchasers, liquidators, or merger partners, as distinguished from a determination of an IRS - acceptable value of the business as a free-standing going concern."1

09 FORM AND EXTENT OF WRITTEN OR VERBAL REPORT.

09.01 The purpose of the assignment will be a major determinant of the form of the report.

09.02 In the case involving tax or taxes implications such as Government taxes, wealth taxes or statutory valuation the appraiser would be required to prepare a formal written report or scrupulously satisfying the requirements of the statute under consideration, along with the rules both as to the format and contents thereof. If the report is for any other purpose, the form content and the extent of the report would be decided as to the requirement of the user.

However, in such cases, language and the documentation of the report normally will be much more informal than a report for the tax purposes.

09.03 Where court cases are involved the type of the report will depend on the preference of the court, the Attorneys involved and last but not the least, the appraisers who will have to present his findings as an expert witness.

09.04 In many cases only a verbal report is expected. This is typical in cases where the information is to be used for tax planning purposes where a general idea give a satisfactory bench mark in the dient to take the decision.

09.05 In any case the appraisal assignment should include as clear specification as possible about the form of written or verbal output product that is expected.

10 DEFINITION OF WHO MADE AND WHO ACCEPTED THE ASSIGNMENT.

10.01 Among professional appraisers, as among chartered accountants who perform audits, the common practice is that the firm rather than the individual appraiser is retained. This protects the client, since
the firm has the responsibility to complete the job without concern about anything that might impair the individual person's ability to perform the work.

10.02 Also it usually do provide for keeping and being able to have perfect the working papers and related records if the occasion should arise to do so later on as is frequently the case.

10.03 Scheduling:

10.03.01 One of the most common practical problems in getting a share valuation done on thorough and timely basis is the lack of proper scheduling, a problem which usually could be avoided with appropriate planning. The scheduling problem usually arises either from a procrastination in making the assignment than widening with a need or desire to have completed on a crash basis or from providing the appraisers with some portions of the information needed. Another common way of scheduling problem is changing some aspect of the assignment mid-way during the project. Procrastination in getting the appraisal assignments made and thus delay in getting the appraiser started to arise particularly from the client or his attorney or his assignment officer or his Chartered
Accountant failing to be decisive in defining the need of objectives in making the appraisal, and particularly from intimating the lead time required to take all the steps required for a thorough valuation of shares. It is the duty of the appraisers once having been contacted to help the client, avoid procrastination by clearly spelling out the steps to be taken and enlighten him of the total time available.

11. RETAINING AN INDEPENDENT APPRAISER

11.01 For many appraisal situations, it is appropriate to retain an independent outside appraiser. This brings to the appraisal situation benefits of professional training experience and their party objectivity. When retaining an outside appraiser all the foregoing elements of appraisal assignment should be considered carefully.

12 SKILL REQUIRED OF AN APPRAISER

12.01 The art of appraising requires the development of three special skills.

1. CLAIRVOYANCE (art of visualising the future and thus to anticipate potential benefits of interest in property as the basis of value).
2. PERSPICACITY (the art and capacity) to reach to the core or essential of the problem of valuation), and

3. GREGARIOUSNESS (the art of understanding the users' (appointers) concept of value and simultaneous ability to communicate to him in his own language).

13 CONCLUSION

13.01 The problems of valuation of shares arises not only from the conceptual aspects discussed in the first three chapters but also from various other aspects. Let us now venture into the fascinating area of valuation of shares in a company for fiscal purposes.