CHAPTER - V.

WOW - STATUTORY METHODS - II

( MAINTAINABLE PROFITS Basis )

1. Introduction:

It is a generally recognised fact amongst the modern investing circles that the normal purpose of the contemplated purchase of shares is to enable the buyer to have an annuity or a regular periodical return on his investment. The investor may be reconciled with the risk of fluctuations in the rate of return on his investment. He may also be ready to face an abnormal situation in which no income may be forthcoming to him for a year (or even years). But under no circumstances does he give up his cherished hope of receiving the return on his investment, because after all the investment is made at all events with the primary object of having a regular flow of income. The expectation of an investor for the return on his investment increases with the passage of time.

Quite naturally, therefore, at the time of purchase of a share the buyer will be inspired by the feeling that it is the earning power of the company concerned that yields income and he will pay for the expected future income of the share. This definitely hints at the determination of the current value of the prospective future earnings of a company for the purpose of fixing the value of its shares. In other
words the value of a share is largely dependent on the present worth of the prospective future incomes which an investor expects to receive on his investment. For all practical purposes the best possible way of computing the present worth of the future earnings on the shares is to resort to capitalisation of the maintainable profits of the company and this approach to the valuation of shares has in its favour the philosophical backing that the current value of the property which is being acquired by an investor depends on the income which one can reasonably expect to obtain over a number of years in future. The basic validity of the maintainable profits approach to the valuation of shares is rarely challenged because (i) the approach has a strong philosophical background and (ii) it takes into consideration the human feelings about the present sacrifice for the future gains.

2. Uses and importance of the maintainable profits basis of valuation of shares:

The method of valuation of shares on the basis of maintainable profits is one of the most modern techniques of valuation which strives to vindicate the reasonably sound principles of valuation for most of the practical purposes. In fact this method appears at first in the mind of the valuer to be very useful whenever he is called upon to compute a fair value of shares on an open market basis under normal circumstances.
With the technological advancement of trade and commerce an investor is at large to make a choice of his appropriate channel of investment. This has hardened his attitude towards the earnings on investment in company shares. Accordingly the valuers are almost compelled to give more emphasis on the income yielding capacity of the investment and therefore, the capitalization of earnings approach to the valuation of shares has assumed greater significance and is now used in all but exceptional cases. 3

Apart from the fact that the method is generally applicable in all normal cases of valuation of shares because it 'seeks to implement the sound principles of valuation in a practical way', 4 the method is particularly adopted in those cases in which the earnings from the shares bear no necessary and logical relation to the assets of the company. Instances may be shown of the companies whose incomes are mainly derived from services rendered and not from the utilization of plant and machinery or any other asset. A company acting as a sole selling agent 5 earns its incomes not generally on the basis of its assets, but on the basis of the services rendered. In these types of companies, valuation of shares should be done on the basis of income or yield which is considered to be the real index of the price that a willing buyer would pay for the shares.
As already stated with more and more investment opportunities now available to the prospective investors, there has happened a revolutionary change in the attitude of the investors in shares and securities towards the shifting of emphasis from the assets basis of valuation to the earnings basis so that a comparative analysis of the value of shares of different companies on the basis of their records of income may be made feasible at the time of investment planning and control. This shifting of emphasis to the earnings basis of valuation is a significant development of the present era and the importance of this change in relation to the valuation of shares has been emphasized by a number of accounting authorities.

Mr. Thomas Greenwood, an eminent English accountant, observed:

"The main object in view in scrutinizing the assets is to ascertain the reliability of the past profit and loss accounts as a guide to the future --- apart from this the book value of the fixed assets is in most cases relatively unimportant. In the old days a valuer focussed his attention on the balance sheet. To-day it is generally realised that for the purposes of valuing the shares, the profit and loss account is perhaps of greater importance than the balance sheet.

Put in other words -- for the purpose of valuing the shares the balance sheet values of the fixed assets are relatively unimportant, because except for a break up value or for the value which they might have in the hands of an optimistic competitor, fixed assets are usually valueless apart from their earning capacity."
Mr. Kripke, an American writer expressed views similar to those of Mr. Greenwood. He said: "Enterprise value is a summation of the present worth of future anticipated earnings. As this fact gains recognition, the income statement becomes the account to which the investor attaches the greatest significance."

The method of valuation of shares on the basis of the earnings of a going concern is commonly used by tax authorities, and has been recognized on many occasions by courts in various jurisdictions. Some observations of the learned judges will indicate the degree of importance attributed to the method under consideration in various courts.

(i) In Fairfax Case, Mr. Justice Halsey Rogers observed in the Supreme Court of New South Wales in October, 1931: "In my view the most satisfactory basis on which to make the necessary investigation as to value is to consider first the figures showing the earning power of the company at the relevant date."

(ii) In Tolley's Case, Mr. Justice Piper observed in the Supreme Court of South Australia in April, 1932: "I think buyers and sellers in an 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."
Abraham's case of the High Court of Australia observed:

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

(iv) In Murdoch's case, the learned judge expressed his opinion in favour of the recognition of earning capacity as a basis of valuation of shares in the following words:

"The main items to be taken into account in valuing shares are the earning powers of the company and the safety of the capital assets in which the shareholders' money is invested."

(v) In Mc Catthie's case, Mr. Justice Williams while pronouncing his judgement in the High Court of Australia made the following observation:

"...A prudent purchaser, therefore, while taking care to see that his purchase money is well secured by tangible assets, would look mainly to the dividends which he could reasonably expect to receive on his shares, and such a purchaser would no doubt expect to receive such dividends as were appropriate to the nature of the business in which the company was engaged. It follows, therefore, that the real value of the shares which a deceased person holds in a company at the date of his death will depend more on the profits which the company has been making and should be capable of making, having regard to the nature of its business, than upon the amounts which the shares would be likely to realize upon a liquidation."
In Beltana Pastoral Co. Ltd. case, Mr. Justice Kitto placed emphasis almost entirely on earning capacity as a basis of the valuation of shares. He extended his support to the valuation of shares on the basis of capitalised profits to the virtual exclusion of the assets backing.

In Clifford's case, the court supported the valuation of shares of D. Clifford Theatres Ltd. on the basis of the capitalisation of the maintainable yield. The learned judge refused to accept the additional asset backing as a ground for enhancing the value of ordinary share already determined by the capitalisation of maintainable yield.
In Mahadeo Jalan's case, the Supreme Court of India expressed the following opinion about the earnings basis of the valuation of shares:

"Where the shares are of a Public Limited Company which are not quoted on a stock exchange or of a Private Limited Company, the value is determined by reference to the dividends, if any, reflecting the Profit-earning capacity on a reasonable commercial basis. But where they do not, then the amount of yield, in other words, the profits which the company has been making and should be making will ordinarily determine the value.......

While supporting the method under consideration, the Supreme Court further observed in the above case: -

"The yield method is the generally applicable method, while, the break-up method is the one resorted to in exceptional circumstances, .......

In Public Trustee Vs. Commissioner of Stamp Duties and in re Crawford's case, the court expressed opinion in favour of the capitalization of maintainable profits for the purpose of the valuation of shares. In pearse's case, Mr. Justice McTernan, Mr. Justice Williams and Mr. Justice Webb gave judicial approval to the method under consideration indirectly when it was held that the valuation of shares in a company which is a going concern
on the basis that the company is in voluntary liquidation at the
time of death savours of unreality and no fair value can be calcu­
lated on the presumption of liquidation in the case of a going
concern. In Sagar's case 21, Mr. Justice Williams held that the
Choice of a method of valuation of shares should be such as to
produce a fair value. Obviously, the best choice of a method of
valuation for a going concern is the maintainable Profits basis
because this method suggests the sound Principles of valuation in
a Practical way for an organisation with continuing operations.

3. Procedure involved with the method:­

Before going into the details of the Procedure involved with the
method, it is useful to look into the meaning of 'maintainable
profits' which constitute the main spring and the pivot round which
the whole process of valuation under consideration moves.

**Meaning of the term 'Maintainable'**  
The dictionary meaning 22 of the term 'maintainable'
is that which can be kept up or
continued. In connection with the method
of valuation under consideration the term indicates the amount of
profits that can be continued or rather expected to continue over
a certain number of years in future. It is a matter more of
expectation based on the realm of calculation from past results
than of actuality.

Although the dictionary meaning of the term 'Profit' is
"the excess of revenue, proceeds or selling Price over related costs?"

**Meaning of the term 'profit'.**  
or "any pecuniary benefit arising from a
commercial operation, from the Practice of a
Profession, ........ " it is in fact difficult to assign any
definite meaning to the word 'Profit'. Economists and Accountants who deal with the concept differ and even the accountants differ amongst themselves as to its correct meaning, although they have a procedural unanimity. Economists from time to time have expressed diverse and conflicting views about the concept of Profit and in fact there exists no complete agreement till today among the economists about the true nature of profit. Profits have been connected by Mr. F.H. Knight with uncertainty, by Mr. Howley with risk-bearing and by Mr. J.B. Clark with dynamic surplus. In fact profits originate from all these sources and that is the reason why prof. B.S. Keirstead opined that Profits arise from monopoly, successful innovation and proper estimate of future uncertainty. Mr. Taussig expressed almost the same sentiment when he said that Profit is a mixed and a vexed income. However, the economists agree that Profits are residual income left after making the contractual payments for various factors of production. In other words, Profits are non-contractual income and as such they may be positive or negative. In this connection it is worthwhile to mention that the economists recognise a distinction between gross profit and net profit. To them gross profit is the difference between revenue and cost and this is identical to accounting profit shown in the profit and loss account of a business. Net Profits are found by subtracting from the gross profits the imputed costs. There exists a difference of opinion among the accountants as to the correct meaning of the term 'profit'.
Accountant views about profit. But the general opinion is in favour of recognising profit as the excess of revenue earned from the supply of goods or services over the cost of supplying them and the cost of promoting their sale. In other words, profit is the residue left out of matching expired costs against revenue and the surplus accrues to the owners.

For most of the practical purposes, the accountants are of the general view that profit arises out of realised increase of assets or earning of fresh assets and is equivalent to the Proprietors' claim against the business in respect of those earned assets which are usually known as revenue.

Courts and lawyers are at times required to express their opinion about the meaning of the term 'profit' particularly when a company intends to declare dividend which can be paid only out of profits. The legal view about the meaning of profit was expressed in Re: Spanish Prospecting Co. Ltd., in which Fletcher-McMullan, L.J., made the following observation:

Legal views about profit. "Profit implies a comparison between the state of business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates. If the total assets of the business at the two dates be compared, the increase which they show at the later date as compared with the earlier date (due allowance of course being made for any capital
introduced into or taken out of the business in the meanwhile) represents in strictness the profits of the business during the period in question. "The legal opinion in fact does not conflict with the accountants' objective view of profit. Instead the task of determining profit has been judiciously left by the court at times to the opinion of the accountants.\(^{35}\)

Meaning of the term 'maintainable profits'.

Now that the meaning of the term 'maintainable' and also the meaning of the term 'profit' in its different perspective understood by different schools of thought have been outlined, it appears to be easy to conceive of the meaning of the term 'maintainable profit' and the context in which such meaning is applicable. In the context of valuation of share the term will signify the level of earnings or incomes which can be expected to be kept up or carried on for a reasonable period in future. The concept is designed to serve the purpose of a balancing instrument between the past earnings without which maintainable profits are somewhat unthinkable because what has to be maintained must first be created and the future expectations which should be so calculated as not to be subjected to criticism as being mere conjecture which immediately invokes the obvious legal criticism that the result of the calculation does not constitute a good evidence. The point that is desired to establish here is that no useful purpose will be served by raising the natural feud between the past earnings and future expectations in ascertaining...
the maintainable profits. The purpose will be best served by striking a balance between the past results or established evidence and the reasonable future probabilities. Thus in computing maintainable profits, not too heavy weight should be placed on past earnings because on the one hand the past is no insurance for the future and on the other hand the result will be criticised as being one of a post mortem operation and at the same time the term "future" should not be stressed to such an extent that the link with the past result is broken and in such a case the result will be criticised as being a conjecture. "Moreover, the forecasting of future profits in the general sense is usually regarded as anathema to the accounting profession."^36

Thus maintainable profits are the result of an appropriate adjustment and projection of past earnings into the realities of a reasonable period in future without in any way ignoring the prospects and uncertainties connected with the future period and as such the maintainable profits constitute a liaison between the past and the future in the process of valuation of shares.

In this connection it is necessary to set at rest the controversy between the future maintainable profits and current maintainable profits. It has already been mentioned that too much emphasis on future in computing maintainable profits and thereby a radical departure from actual results may lift the process of valuation out of the realm of
calculation into that of conjecture. So what is required for the present purpose is current maintainable profits which can be ascertained by prudently adjusting the past results in respect of any relevant factors which are inherent in the situation at the time of the valuation of shares. 37

An approach to the valuation of shares on the basis of maintainable profits valuation would need a careful consideration and determination of two important factors viz., (1) the amount of maintainable profits and (2) an appropriate rate of capitalisation of the maintainable profits.

(1) Determination of 'Maintainable Profits':

Determination of maintainable profits is not a simple job. In fact, the task is complicated and delicate, because it involves not only the objective consideration of the available financial information and accounting figures but also subjective evaluation of many other factors, such as general economic situation, managerial potentialities of the company, political situation, future Government policies, stability of Government and the possibilities of changes in future etc. It may be possible to lay down guiding principles in respect of objective considerations and it is wise to leave the subjective matters to the discretion of the valuer who is expected to be efficient enough to give due weight and consideration to each of the subjective factors according to his own reading of the facts and circumstances of the case under his review.
The three fundamental steps normally taken by a valuer for the purpose of determining the maintainable profits of a company are:

(x) determination of the past average earnings;

(y) projection of the past average earnings into future and adjustment necessary in respect thereof;

(z) adjustment of preferred rights of creditors and preference shareholders.

These steps are discussed in greater detail below.

(x) Determination of the past average earnings.

The determination of past average earnings is the function of making decision as to the number of years whose authenticated results are to be taken for the purpose of averaging. The work is not so simple as it may seem to be. Selection of a certain number of years needs a passionate consideration of current economic situation and past events which affected the past results. Any mistake in regard to selection of years for averaging may foil the honest desire of computing a proper value of shares. Simple selection of a number of years for averaging is not enough. Appropriate adjustment of the profits to make them acceptable for averaging is a far more important issue. Proper guard must always be taken against the danger of indiscriminate averaging of values because in such a case the outcome may lead to a grave injustice, a right warning sounded by Mr. Justice Williams in the Daandine pastoral Co.Ltd. case.\(^36\)
Basic issues involved in determining the past average earnings.

In calculating the past average earnings it is necessary to make decisions on three important matters.

(A) Selection of a certain number of years whose results are to be taken for averaging.

(B) Adjustments to be made to the profits of the selected number of years.

(C) Selection of appropriate process of averaging to be adopted.

(A) Selection of the number of years:

The selection of a few years, however easy and simple the task may look to be, is in fact a risky and tedious exercise, particularly when the valuer is bound to work within some limitations.

It has to be frankly admitted that the valuer has to assimilate effects of socio-economic and political forces which are beyond his control, but such factors shall have a bearing on the future profits of a particular company. The valuer may not have enough time and resources to undertake a complete balancing of all factors affecting the profits of the years to be selected for averaging. He is usually required to work on the basis of the earnings reported by the company for recent years after making an upward or downward adjustment to the available figures in accordance with his own appraisal of the total effect of the factors
which in his opinion will have a bearing on the working of the company. It is not an easy attempt to have a precise forecast of annual variations for a number of past years into future. Generally, if the earnings of a company are reasonably stable, the task of selection is easy. But if the earnings fluctuate far away from the horizontal trend line or if there is a frequent upward or downward trend of earnings, the job of selection becomes complicated. Furthermore, the valuer on the basis of his practical experience understands that formulae and rules of thumb change with time and as such the simple use of the average of past few years even with some weights has no validity without careful analysis of the present and future conditions particularly when technological change appears to be the order of the day.

However for all practical purposes a selection of a few years has to be done. An estimate of future earnings has to be prepared over an arbitrary time horizon which should normally be a period short enough to justify a reasonable degree of confidence in the earnings expected in future. But the most significant consideration is that the selection of a number of years for averaging has to be done in such a way that the whole period of time represents a normal picture of both the good and bad years in the company's recent history. Thus the number of years selected should be reasonably large enough in order to cover the length of a business cycle (Prosperity, recession, crisis and recovery) which of course varies
Selected number of years to cover the length of a business cycle. Normally of years to cover the length of a business cycle. Normally an average for a shorter period is not considered to be a fair average for a business which is subject to cyclical fluctuations.

When a shorter period may be adopted. On the contrary, if inflationary conditions prevail a shorter period of say two to three years may be selected because during a period of rising price uncertainty as to future earnings is a common economic phenomenon and it over-shadow the business atmosphere. It is a difficult attempt to have a precise forecast of future earnings. Similarly, if the profits of a company over a period of say five years showed a steady and considerable increase or if a company has achieved a steady and gradual growth, an average calculated on the basis of three years, or, in special circumstances, even two years may be considered to be a fair average. In some cases, average of a still shorter period say one year's earnings may be more helpful in forecasting future earnings, for instance where a change in the nature of the business or a change in the trading conditions is in sight the valuer may decide to rely on one year's profits and may discard earlier years as being irrelevant and of no significance.

Selection of years in a stable company. If the earnings of a company are reasonably stable or fluctuating round a more or less horizontal trend line, the selection of certain normal years is easy. A 3-yearly average may reflect the fair future earnings of a company.
Selection of Again, if a company has been in existence for
years in a company with allong period of time, the period over which
the past profits are to be examined should be
long existence. at least three years. It may even be five
years. But under no circumstances the period should include the
first year of a new company's existence unless the company took
over the business as a going concern from someone else because the
first year of most new businesses is a year of establishment,
expedition and experiment.

The problem of selection of the period over which the past
profits are to be examined and averaged for the purpose of estimating future earnings
received judicial attention in many cases and at this stage it will be worth-while to
refer to the views of the learned judges relating to the selection
of the period for averaging past profits.

(1) Mc Cathie's case :- Profit of one year immediately before
valuation date was selected to serve as guide to future projection.
The accountant who valued the shares on behalf of the company took
an average of the profits for the last three years, viz. 1938
(£4,237), 1939 (£5,786) and 1940 (£11,495). The learned judge
discarded the 1938 and 1939 years as being affected by abnormal
factors and he considered it safer to work mainly on the 1940 year,
because of the fact that the percentage of gross profit was nearer to
the normal rate from that type of business.
(ii) Baynes's case: While selecting the period for averaging past profits, to serve as a guide to the projection of maintainable profits, the results of an exceptionally bad year can not fairly be taken into account.

(iii) Clifford's case: In this case the court adopted a five-yearly average and this five-year period was considered as a fair measure of maintainable profits.

(iv) Crawford's case: The court adopted the average of the income over the period of five years including the last year of depression so as to neutralize the effects of good and bad years. In this case it was said that "..........in view of depression from 1931 - 1935 a reasonable course to adopt in the valuation of the shares ........would be to take the average of the income over the period of five years before March, 1939," but "the small profits of the year 1934-1935 would..........be more properly allocated on the basis that it will probably occur only once in ten years. On this basis the four subsequent years average £ 1,786; for nine years this would give a total income of £ 16,074. If there is added to that the net income of £ 310 for the year 1934-1935 the average for each year is £ 1,638."

(v) Hoeking's case: In this case a long period of eight years was adopted so as to indicate whether the business was growing, static or receding.

(vi) Emanuel's case: In this case the court adopted the average profits for 10 years. One of the reasons for the acceptance
of such a long period was to take into account the fluctuations in world prices.

Apart from the utterances of different courts about the selection of the member of years, several authorities on Accounting and valuation have also expressed their opinion about the selection and approval of the period over which the past profits are to be examined.

(i) H.E. Seed: He suggested that exceptional periods which are affected by strikes, financial crises and the like should normally be avoided. But he proposed to consider a long rather than a short period in order to average the effects of good and bad phases in the life of a concern. Mr. Seed states :

Opinion of some authorities on the number of years to be adopted for averaging. "There may be adverse or prosperous conditions which may be considered as circumstances incidental to the trade, which are liable to recur from time to time in the future. . . . . . . . . where their presence is indicated, it may be an argument for taking a longer rather than a short period as the basis of the calculation, so as to average the good and bad years." 51

(ii) The Accountants' Handbook (New York):-

"The period covered should generally be from three to ten years, depending on the circumstances. In most cases it is either unnecessary or undesirable to go back for more than five years; on the other hand, one year is too short a period to afford a basis for judgement." 52
(iii) R.K. Yorston, E.B. Smyth and S.R. Brown:

The authors are of the view that the period to be covered for obtaining an average is normally from three to five years, but it entirely depends on the necessity for attaining normality. If there are good reasons, a shorter or longer period may be adopted. If it is possible to establish that one year, apart from all others, is a normal year, that year only may be considered as the basis.

(iv) Geo ovens and Donald I. Beach:

"Formulae and rules of thumb change with time. The use of the average of the past five years' earnings, three years' earnings, past earnings with different weightings for different years, and other such formulae have no validity without careful analyses of present and probable future conditions. Earnings multiples and other such statistics fluctuate drastically from one period to another." 53

(v) R.L. Sidey:

According to the author the period over which the past profits are to be examined may be five, three or even two years according to the facts and circumstances of each case. There can be no iron rule.

(vi) A.V. Adamson:

"The period must be sufficient to indicate whether the business is growing, static or receding, as it must be remembered that the object of studying past results is only for the purpose of making a reasonable estimate of maintainable earnings." 56
What transpires from the above discussion is that no hard and fast rule can be laid down as to the selection of the period over which the past profits are to be examined. The whole exercise is to be conducted with an eye on the necessity for achieving normality. "The main question for decision is how many, and which years would give the most reliable indication." In this connection the important points to keep in mind are:

Dynamic approach
(a) The period to be covered for obtaining an average may be a shorter or longer period depending upon the facts and circumstances of each case. It is a dangerous attempt to lay down some formulae or to have a purely mechanical approach for the selection of the period over which past profits are to be examined.

(b) The whole exercise of selection of the number of years should centre round the necessity for achieving normality. It is, therefore, quite natural that the years chosen for averaging the past results should be normal years. Normal years mean the years which are not affected by exceptional circumstances that have the least possibility of recurring from time to time in the future. Thus if a company has incurred a loss in a particular year, it does not essentially become an abnormal year. On the other hand, if the happenings in a year are such as would give a distorted average even after adjustments, it is better to exclude the year as abnormal.

(c) While moving in quest of normal years, it is pertinent on the part of the valuer to keep a close watch on the prevailing
socio-economic and political situations so as to assess their impact on the future. Similarly the probability of any change in the socio-political order and economic conditions in the future should be adequately considered. The endeavour is to deal with the future in the light of the past and therefore, where necessary the valuer must modify his opinion in accordance with known factors which are reasonably likely to occur in the future.

(d) The task of selection of the period for averaging past profits remains imperfect without a careful consideration of the length and nature of the business cycle which varies from industry to industry. This is particularly important for the businesses which are vulnerable to cyclical fluctuations.

(e) If good reasons are shown and where it can be definitely stated that one year apart from all others is a normal year, that particular year may be selected. But normally it is not fair to take the first year of a new company's existence because "the first year of most new businesses is one of the establishment." In this connection it is useful to keep in mind that under certain circumstances it is almost impossible to select any year as a normal year without appropriate adjustments. For instance, in a developing economy like India, where most of the businesses are engaged in their expansion and development programmes, it is hardly possible to select any year as a normal year without some material changes and adjustments which are necessary for making the past results fit to be used as a reasonable guide to normal earning capacity.
It is now possible to conclude the above discussion by outlining the following important factors which normally affect the selection of the period over which the past profits are to be examined:-

Important factors affecting the selection of the number of years:

1. The nature of the business and the status of the business.
2. The trend of earnings.
3. The length and nature of trade cycle.
4. The stability of earnings.
5. The prospect of the company.
6. The position and profitability of the business.
7. General economic conditions.
8. Social and political environment.

The list of the factors is not exhaustive. While some of these factors may be considered as important in one case, others may influence in another case. Apart from these factors, where necessary, the valuer is free to consider any other important factor which is reasonably likely to occur in the future.

(5) Necessary adjustments to be made in averaging the past earnings:

Having selected a period over which the past profits are to be examined, it is now possible to proceed to average the past earnings for the purpose of ascertaining the true earning capacity of a company. But the valuer
may be required to carry out some adjustments in averaging past earnings so as to make the past results a reasonable guide to normal earning capacity. Again, the primary source of information for the valuation of shares under maintainable profits basis is the profit and loss account of a company and in spite of the fact that 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 profit and loss accounts, there may still be the necessity of making some adjustments which the valuer may consider to be fit to make the figures of earnings more reliable. R.L. Sidey, an eminent accountant is also of the opinion that ".........in valuing shares it is not always proper to take into account merely the Nett Profit disclosed each year by the profit and loss Account," for the simple reason that incorrect valuations placed upon the assets of a company will affect the profits. For instance, secret reserves created by a conservative valuation of floating assets particularly stock and book debts, or by writing off excessive depreciation, may not be prohibited by law as these act as a good stabilizing factor, but "in endeavouring to arrive at the true profits of the company for the purpose of valuing its shares, such hidden reserves are to be disregarded, as they are not a true charge on the profit and loss account before arriving at the Nett Profit........." A.V. Adamson also expressed his opinion in favour of making necessary adjustments to the past results, as he wrote about the
Adamson's views about the need for making adjustments, variations from past earnings in certain circumstances. In his view departures from the established figures of past earnings are necessitated by variations in capital employed, change in management, any vital change or anticipated change affecting profits since the last balance sheet date and other events occurring before the date at which the valuation is required. In a number of cases the courts also entertained applications with prayers for making adjustments in the computation of maintainable average profit. Before outlining the various decisions of the courts regarding adjustments to be carried out in averaging the past earnings, it is better to take stock of the adjustments which a valuer normally proposes to make in determining the future maintainable average profit. The more important of adjustments are as follows:

(1) Depreciation: In the case of depreciation it is necessary to see that the provision for depreciation in each year is adequate and has been made on sound and correct Principles. Adequate depreciation means proper depreciation calculated consistently both as to basis and rates. It also signifies that the amount of depreciation should not be unduly large or unduly small. If the provision for depreciation is in excess of the proper depreciation, hidden reserve will be created. On the contrary, if the amount written off as depreciation is less, the result will be inflation of profit. In both the cases the Profit and loss account will fail to exhibit the true and fair view of the profit or loss of the company and the results of the earnings shall never be
considered to be beyond dispute and will always be subjected to adjustment to be made by the valuer. While making adjustment to the past earnings in respect of depreciation, the valuer must keep in view the guidelines laid down in the Companies Act as to the methods to be followed in calculating depreciation for which provision has to be created by the company before the determination of profit out of which dividend can be paid. It should be noted here that there is nothing in the Companies Act, 1956 which prohibits switching over by the company concerned from one method of depreciation to another method as permitted by the Companies Act. For example, after several years of charging depreciation on the straight line basis, the company may adopt from a certain later year the reducing balance method of depreciation applying the income-tax rates of depreciation. For the purposes of valuation it is not desirable that there should be any inconsistency in the method of depreciation followed by the company. If there is any such inconsistencies, suitable adjustments may be necessary.

(2) Abnormal and non-recurring items:

Some adjustments may be necessary to eliminate the effects of abnormal and non-recurring items on profits, because earnings affected by non-recurring factors or abnormal situations can not be used as any reasonable guide to normal earning capacity. Thus it is essential to eliminate such material non-recurring items as loss of exceptional nature through strikes, lock-outs, fires, floods, cyclones and other natural calamities, accidents, thefts, etc.
Similarly, gains from any isolated transaction not being any part of the normal business of a company, lump sum compensation, damages and costs in legal actions, Government grants, receipt of awards and commissions in a particular year for rendering special and commendable services, abnormal war-time gains, unusual gains from business during unprecedented political crisis like heavy influx of refugees from other countries, riots etc. should be eliminated in order to arrive at the amount of profit which may be treated as normal and of recurring nature. But while eliminating the effects of abnormal items, the valuer has to remember that it is very difficult to find a year which may be treated as a normal year in the true sense of the term. "..............no year is a normal year, there are always items which are peculiar and non-recurring. It would be unwise to assume that future profits will not be affected by extraneous expenditure and income."71 This statement is not intended to condemn the process of eliminating the items of abnormal nature. The purpose is to caution the valuer to take great care and to exercise a good deal of judgement in sorting out the material non-recurring items to be eliminated. The valuer would do well to identify only abnormal and non-recurring items of such a nature and magnitude that their repetition could hardly be expected. 72

(3) Profits or losses of some non-trading assets :-

In determining the future maintainable profits, an adjustment may be necessary in respect of profits or losses derived from
certain non-trading assets which are excluded from the capital employed. For instance, a company having surplus funds which, at least for the time being, can not find employment in business may make investments and any income derived therefrom has to be eliminated in calculating the past earnings to be averaged. In connection with the elimination of 'income from funds not required', Adamson stated:

"The theory of capitalized earning capacity is applicable in the main to trading and manufacturing activities. There are some concerns which combine trading operations with the holding of investments, and others which, while mainly engaged in trade or manufacture, have surplus funds which are invested either within or without the business. The income, if any, from these surplus funds should be ascertained and deducted from the earnings to be used for the determination of maintainable profits."

(4) **Capital items** :-

Any profits or losses or incomes or expenses in the nature of capital included into the profit and loss account should be eliminated in order to instil a greater degree of reliability into the past earnings as being true and fair profits which may serve as a guide to the projection of maintainable profits. Thus profits on sale of some old furniture or loss on sale of obsolete machineries are not normal profits or loss and therefore, should not be allowed to distort the past earnings.
(5) Provision for liabilities:

All necessary provisions for liabilities for, say, taxation (discussed later on) or otherwise should be made. Adjustments may be necessary regarding such provisions as provision for doubtful debts, gratuities, pensions etc., particularly when such provisions do not appear to be adequate in the judgement of the valuer. While adjustments are made for provisions for liabilities proper regard must be had for any matters suggested by notes appended to the accounts audited by the auditors or by qualifications in their report.

(6) Management remuneration:

Past earnings are to be calculated after making proper charges for remuneration to directors and other managerial personnel in accordance with the provisions of the companies Act. Managerial remuneration should be reasonable and not too much or too less. If the management remuneration appears to be a meagre amount, it is possible to conclude that the directors and others for whatever reasons have foregone their reasonable remuneration and in such a case an adjustment is to be carried out in averaging the past earnings in respect of any remuneration, commission etc. foregone by directors and/or others in the management of the company. Conversely, if the management remuneration appears to be excessive, the directors and other interested groups in management may run the risk of being sued under the companies Act on the ground of oppression and mis-management. Thus the valuer shall,
in all probability, lighten his task by taking into consideration a reasonable amount of managerial remuneration as enunciated in the companies Act.

(7) Valuation of floating assets:

Adjustments may be necessary to eliminate the effect of hidden reserves created by a conservative valuation of floating assets, particularly stock and book debts on the past earnings of the company. It is equally important to make corrective adjustments for the over valuation of floating assets. In the case of stocks it is necessary to see that a consistent basis of valuation is followed year after year. So far as the valuation of book debts is concerned, the valuer has to see that a fair estimate of bad debts and also of the adequate provision for doubtful debts was made by following some scientific procedures established by the company on the basis of its past experience and expert recommendations (if any) of the auditors. If the classification of book debts into good, doubtful or bad as required for the balance sheet of a company is not made on the basis of some sound and rational Principles, established for the company concerned, some adjustments may be necessary to eliminate the effects of haphazard valuation of sundry debtors on the past results of the company.

(8) Retention for Reserves:

Retention from profits for reserves is necessary for such purposes as absorption of possible losses in future, stabilization of dividend, expansion of the company, replacement of fixed assets
at higher prices, and meeting various unknown contingencies of future. Such retentions are very important from the point of view of the future of the company. But while estimating future maintainable profits the retentions from profit for various types of reserves are considered to be mere transfer of profit from one account to another and such transfer of profits to (say) general reserves, dividend equalisation fund, sinking fund for redemption of liabilities should not be taken note of as these transfers do not affect the basic nature of the profits or their availability. Of course, such transfers to reserves are important consideration at the time of valuation of shares on the basis of dividend that can be expected in future by an investor and this basis of valuation of shares is considered later on in this chapter.

(9) Charge for Income Tax and Other taxes:

While estimating the future maintainable profits, it is necessary to make proper provision for taxation. The significance of income tax and other similar taxes in the computation of earnings will be clear from the following succinct opinion of professor W.A. Faton, the celebrated American authority on Accounting:

"All taxes are basically alike in their relation to business revenue and profit. The differences are largely in method of measurement. Whether based on sales, Property value, amount of
pay-roll, physical output, or some technical income computation, they represent charges which must be met before a true net to private capital emerges." 80

The English legal and accounting opinions are in favour of deducting income tax, excess profits tax etc. in drawing up the profit and loss account. In the case of G.E. Clivivant & Co. Ltd., Lord Greene observed:—

"It is indisputable that for the purpose of drawing up the profit and loss account of a trading company excess profits tax must be deducted if ordinary commercial practice is to be followed .........."

With regard to taxation, the Institute of Chartered Accountants in England and Wales is of the opinion that —

"(a) the charge for income tax should be based on the profit of the year and should be so described;

(b) any material adjustment in respect of amounts charged in previous years should be shown separately;" 82

In other words, charge for taxation should be shown in the profit and loss account. In America the accounting opinion is in favour of treating income tax as a charge in revenue account. Income taxes are an expense and should be treated like other items of expenses. 83

The position in India with regard to charge for taxation is not different from that in the U.K. or the U.S.A. A company in India
is required to pay income tax on its profits, sur-tax on excess profit and various other taxes and as such the charge for taxation is a proper item in the debit side of the profit and loss account. Schedule VI, Part II, of the Companies Act, which provides for the requirements as to profit and loss account of the companies stated:

"3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose...........................

(vi) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation."

Moreover, the estimated amount for taxation has to be shown as provision for taxation in the balance sheet and it is an established principle of accounting that provision is a charge against profit.

Thus the maintainable profits are to be calculated after the deduction of a proper charge for taxation. Since it is difficult or rather impracticable to foresee the future rates of taxes, the current tax rates applicable to a company may be applied to the past profits which must definitely be taken after all other
adjustments. But it is not necessary to take into account the special types of reliefs or rebates allowed under the Income tax Act in any year or years for the simple reason that any special incident affecting the profits of past years should be avoided in calculating maintainable profits. This is so to say to give a touch of normalcy to the past results. Thus investment allowance, development rebate/allowance, rebate on export turnover, relief to new industrial undertakings, or hotels, or new ships, relief to industries in some special cases or relief for accumulated losses allowed under the Income Tax Act, should be disregarded in calculating the past average profits. Since the past profits, and not the distribution thereof by way of cash dividends or bonus shares, are considered for the present purpose, tax on dividends or on bonus shares is not relevant and should not be taken into account in calculating the maintainable profits. But some adjustments are necessary for the deduction of surtax paid by the company during the past years.

(10) Miscellaneous adjustments: -

The attempt to prepare an exhaustive list of adjustments necessarily to be carried out in averaging past earnings is not only difficult but also a dangerous step. None but the valuer knows what adjustments are appropriate to calculate the maintainable profits in accordance with the facts and circumstances of the particulars case. Normally, the possibility of some departure from the established figures of past earnings can not be ruled out under such compelling circumstances as the following: -
Change in management - Where evidence shows that the earning capacity of a business will be affected radically by a change in management or management policy, some recognition must be given to the altered circumstances. Adamson is of the view that "a change in management should be a factor for consideration in assessing value", particularly when "a change in management, or management policy has taken place sufficiently long before the date of valuation to enable its effects to be reflected in ascertained earnings." In these cases the valuer can use the new scale of earnings as his base for calculating maintainable profits.

New undertaking in which full productive capacity has not been attained -
In the case of a new business in which full productive capacity has not been attained, the actual results obtained can not be used as a proper guide to maintainable profits because some attempts must be made to anticipate what level of maintainable profits would be reached on the basis of full production and its marketability. Some sort of modification of the estimate may be warranted by any doubt as to the disposal of the larger volume of production or by any probability of exceptional variation in costs.

Changes in capital -
The effect of any increase or decrease of capital upon earnings is definitely a matter of consideration by the valuer. It would be competent for the valuer to make proper
adjustment to the past earnings by a careful study of the effects of the changes in capital on production, distribution and profits of the business.

d) Surplus funds -
It has already been hinted that income from surplus funds which, for the time being, can not find employment in a company should be isolated and deducted from the earnings to be used for the determination of maintainable profits. But it is necessary to mention at this stage that investments in government or non-government securities representing any provision or fund created for the replacement or extention of any asset or for meeting any known liabilities of the future should not be adjudged as surplus funds. In the words of Adamson, "surplus funds may be regarded as those which could be distributed to the proprietors without impairing the earning capacity of the business as a going concern." 92

e) Any other material change or anticipated change since last balance sheet date -
Besides the changes in business already noted above, there may have occurred some events which will have a bearing on the determination of maintainable profits. For instance, after the last balance sheet date but before the date of valuation, one particular branch or section may be closed or sold, or a new branch or department may be established. There may also
be some transactions or happenings or some vital changes which, although they had not actually taken place at the date of valuation, yet were foreseen as a reasonable expectation before the date of valuation. In all these cases the valuer will be duty-bound to make a sincere effort to measure the effects of the changes or anticipated changes on the maintainable profits. The above instance of adjustments necessary for determining the maintainable profits should be considered to be only a few amongst many items. Needless to stress that the valuer is the appropriate person to gauge the effects of the various circumstances, events or altered situations on the past results of a company and thereby to sort out the necessary adjustments to be carried out in averaging the past earnings.

Before concluding the discussion on the necessary adjustments relating to the computation of maintainable average profits, it is better to have a glimpse of the decisions of the court regarding the adjustments.

(1) L.C. Ltd. Vs. G.B. Ollivant & Co.Ltd.

In this case Lord Greene was of the opinion that for the purpose of drawing up profit and loss account of a trading company excess profits tax must be deducted. He further stated:

"It is not merely common knowledge, but common sense that the divisible profits of a trading company can not be properly ascertained without first making that deduction."
(ii) Mc Cathie's case

(a) Directors fees - The fees of the directors were curtailed to a reasonable amount and the excess fees of the directors were added to the company's profits. In this particular case the total fees of the directors who had only one regular meeting in each year, were £ 6,980 including £ 1,800 per annum to a woman of 76 years and £ 1,450 to another woman aged 70 years. Williams, J., stated:

"There is nothing seriously irregular in distributing the profits in this way whilst the company remained a family company and the shareholders approved, but in estimating the reasonable earning capacity of the company's business, I agree......that at least £ 3,800 should be deducted from the directors' fees and added to the company's profits."

(b) Depreciation -
Williams, J., disallowed the amount of excess depreciation and treated the excess as additional profits.

(c) Taxation -
The adjustment of profits for each of the averaging years by taking taxes payable and not paid to arrive at the true average annual profits received judicial recognition in this case. The learned judge "approved the adjustment of book profits by substituting for the taxes shown, the taxes actually payable in respect of the years concerned."

96
(iii) Martin's case

(a) Taxation - Taxes payable, and not paid in each of the averaging years should be the proper charge in the profit and loss account before arriving at the net profits to be averaged.

(b) Depreciation -

The amount of depreciation charged on the basis of the amount allowed for tax purposes, was considered to be the fair charge. The learned judge "approved the adjustment of amounts deducted in excess of those claimed in the income tax returns, by treating the excess as additional profits".

(c) Share of profit from subsidiaries -

The adjustment for substitution for dividends received from a controlled subsidiary company, of the share of actual profits applicable to the share interest of the parent company, was approved by Williams, J.

(d) Stock reserves -

Williams, J., allowed the creation of a substantial stock reserve. He even did not compel the companies concerned to write back the reserve to calculate the normal profits.
The directors of the companies concerned valued stocks on hand at 30th June, 1940 at prices applicable to those ruling at 30th June, 1939. As the figure adopted was £36,441 less than 1940 values, a substantial stock reserve was created leading to the reduction of profit by £36,441.

The learned judge did not approve of the adjustment for the stock reserve.

He stated:

"The sum of £36,441 was no doubt a profit in the strict sense. But it was book profit which might or might not eventuate. The importance of the stock reserve lies, I think, in the fact that it shows that the directors were adopting a conservative policy well calculated, even if values fell steeply, to enable the company to pay a steady dividend, and if they did not, to create a considerable potential profit."

(iv) Tremaine vs. Commissioner of Stamp Duties

This case related to the valuation of shares in a small company not long in existence, in which the number of shareholders was only three. Smith, J., was of the view that the death of an efficient managing director would have a detrimental effect on the earning capacity of a company. The learned judge further stated that the possibility of increased taxation is an important factor in the valuation of shares.
(v) Abrahams' case

(a) Taxation -
Taxes payable and not taxes paid should form an element in determining the true profits in each of the averaging years.

(b) Management -
No regard was paid to the adjustments because of the outstanding ability of past management.

(c) Income from idle cash -
The learned judge approved of the inclusion of estimated additional income from idle cash in future maintainable profits.

(vi) Clifford's case

(a) Allowance for loss of a director -
In this case no regard was paid to the need for adjustments because of the outstanding ability of past management. No allowance was given for the loss of a director. In the judgement it was stated:

"No doubt outstanding business capacity may be shown in the motion picture business as in most other businesses, but we find it difficult to
believe that it is a business in which any particular individual is irreplaceable”.

(vii) Beltana Pastoral Co. Ltd. case

a) Livestock values -

The valuation should be made at a figure which is more in line with cost or market price as determined in an ordinary trading business. An adjustment may be necessary to the past earnings in order to bring the opening and closing stock from artificial figures to real values. In the above case Kitto, J., stated that "the real value of the shares can not be diminished by reason of the fact that in the years chosen for the purpose of obtaining an indication of future profits the company had kept its books on the basis of artificial opening and closing stock figures, which were right enough for taxation purposes but which differed from those which would appear in future accounts if they should be kept on a normal trading basis”.

Concluding remarks and limitations to adjustments

While concluding discussion on the necessary adjustments to be carried out in averaging the past earnings, it has to be stressed that no common list of adjustments can be
given. Each particular case must be considered on its merits with particular attention to the objective of using the past earnings as a guide to the future maintainable profits.

Under normal circumstances adjustments are necessary in cases where the past earnings are affected by abnormal and non-recurring factors. But in any business some abnormalities like excessive costs of repairs, huge expenses on advertising campaign, payment of retirement benefits to employees, large expenditure on workers' welfare schemes etc. are bound to arise from time to time. Where the recurrence of one or more of such types of situations from year to year is considered to be almost a normal expectation, it would be wiser not to make any adjustment.

To say the least, the valuer is the prime authority to assess the prevailing situation and to decide upon the adjusts necessary for a particular case after a careful and dispassionate evaluation of the facts and circumstances of that particular case. In the process of making adjustments he would, of course, do well to remember the wise opinion of Adamson, an eminent Australian accountant who concluded his discussion on study of past earnings in his book by making one of the very significant remarks that "care should be taken not to carry adjustments to extremes."
Selection of appropriate Process of averaging:

In the process of making a valuation of shares on the basis of future maintainable profits, some consideration should always be given to the selection of the appropriate process of averaging the adjusted profits of the selected number of years. Of course, no question of averaging comes in case one year, apart from all others, is taken to be the normal year and profits of that year only are considered. But where it is desired to prepare an estimate of future earnings over a selected period of time so as to instil a reasonable degree of confidence in the expected earnings, there is no alternative to resort to the process of averaging. There is two-fold justification for the averaging process. Firstly, the process is definitely an attempt to determine a level of maintainable profits. It is conceptually valid to base a business valuation on a level of estimated future earnings. The method at least seeks to measure the future income flow and does not accept past performance without question. Secondly, the practice of averaging ensures that at least an attempt has been made to take into consideration the effects of the periods of prosperity, recession, crisis and recovery in a business which can never be expected to be relieved of such cyclical influences.
The applicability of the process of averaging has to be considered with reference to four important economic situations faced by a business. These are - (1) Widely fluctuating profits; (2) Profits showing a somewhat regular upward or downward trend; (3) Markedly rising or falling profits; (4) Profits showing a continually rising trend in industries with high growth potential.

(1) Widely fluctuating profits:

If the past results of a company as indicated by the profit and loss accounts show wide fluctuations from year to year for any reason whatsoever, an average will fail to yield the much-needed average maintainable profits and any projection of future profits by means of the average of widely fluctuating profits is bound to flop for the simple reason that most fantastic results may be available because of the attempt to average certain extremely swinging figures of profits that are, most probably, affected by various factors which may not be truly comparable.
The danger of averaging widely fluctuating profits may be illustrated with the help of the following hypothetical figures:

Company X Ltd.

<table>
<thead>
<tr>
<th>Year</th>
<th>Profits earned Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5,000.00</td>
</tr>
<tr>
<td>2</td>
<td>1,500.00</td>
</tr>
<tr>
<td>3</td>
<td>12,000.00</td>
</tr>
<tr>
<td>4</td>
<td>3,000.00</td>
</tr>
<tr>
<td>5</td>
<td>2,000.00 (loss)</td>
</tr>
<tr>
<td>6</td>
<td>4,500.00</td>
</tr>
</tbody>
</table>

Mathematically the mean of the above results is Rs. 26,000 - Rs. 2,000.00 = \( \frac{24,000}{6} \) = Rs. 4,000/-.

The average profits for the six years Rs. 4,000 bear little relationship with the earnings of the six years. The horrible picture of this type of average will be clear from the following graphical representation (Figure-1) of the results of the above six years.

![Graphical representation](image-url)
A sensible valuer will immediately reject this average as being truly uncomparable, unrepresentative of the happenings in the six years and fallacious. The wide fluctuations of profits from year to year have marred the whole exercise of averaging with the only result that an apparently irritated valuer may term the average as a big hoax and a mockery about the actual situation in the business.

Thus where there are wide fluctuations in profits caused by uncertainties as to market, production capabilities, management, financing etc., it is of no use to calculate an average. "The use of earnings averages...is appropriate only where the long-term average earnings potentials is constant". In these cases of wide fluctuations in profits, the course of action to be followed by a valuer should be to study the whole history of the company together with the earnings of the company for a fairly long period in order to form an opinion about the maintainable profits. One of the glaring examples of the decided cases in which the judges considered the history of the company and of the industry together with profits for a long period of time is Trustees of J.T. Salvesen vs. I.R.C. Where Lord Fleming not only spent much time in considering the history of the company and of the speculative industry of whaling, but also reviewed the progress of the company. He stated:
I think that as this company has been in existence for over twenty years it is not unfair to take account of its profits and losses during the whole period it has been trading, ...."

Another instance where history of the company was considered by court as very important was that of Holt Vs. I.R.C. Here Danckerts, J., reviewed the profits of the company for quite a long period of time from 1912 to 1947 and took note of the effects of first war, slump in 1931 and the huge amount of profits earned during the second war.

(2) Profits showing upward or downward trend:

In the process of making a valuation of share, there is a deep-rooted convention of taking the simple average of the profits of a company for (say) last three, five or ten years. The use of this type of simple average of past earnings may be appropriate in the case of established industries with no growth prospects. Where the profits of a company show a regular trend, either upward or downward, an average of the cycle can be profitably used for determining the average maintainable profits. An illustration is given below:

The Convention of using simple average.
Company X. Ltd.

<table>
<thead>
<tr>
<th>Year</th>
<th>Profits Rs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5,000/-</td>
</tr>
<tr>
<td>2</td>
<td>12,000/-</td>
</tr>
<tr>
<td>3</td>
<td>15,000/-</td>
</tr>
<tr>
<td>4</td>
<td>8,000/-</td>
</tr>
<tr>
<td>5</td>
<td>6,000/-</td>
</tr>
<tr>
<td>6</td>
<td>9,000/-</td>
</tr>
<tr>
<td>7</td>
<td>11,000/-</td>
</tr>
<tr>
<td>8</td>
<td>13,000/-</td>
</tr>
<tr>
<td>9</td>
<td>10,000/-</td>
</tr>
<tr>
<td>10</td>
<td>7,000/-</td>
</tr>
</tbody>
</table>

The simple average for the ten year's profits (Rs. 96,000 / 10) may be accepted because the profits have shown a definite trend with a sort of regularity. The average of the profits of the first cycle of the business during the first 5 years is (Rs. 46,000 / 5) = Rs. 9,200/- while that of the profits of the second cycle during the last 5 years is (Rs. 50,000 / 5) = Rs. 10,000/-. The simple average of the two cycles or the average of any of the two cycles may be taken to serve the purpose. The position may be more vivid from the following graphical representation (Figure-2) of the above two cycles of the business.
But if the profits indicate an upward or downward trend without any cyclical regularity, simple average may be of little help for the future projection of maintainable profits. The following illustrations may be given.

<table>
<thead>
<tr>
<th>Company - X</th>
<th>Year</th>
<th>Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>4,000</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>9,000</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>18,000</td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>$49,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Company - Y</th>
<th>Year</th>
<th>Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>18,000</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>12,000</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>9,000</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>6,000</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>$49,000</td>
</tr>
<tr>
<td>Average</td>
<td></td>
<td>$9,800</td>
</tr>
</tbody>
</table>
Can these averages help the valuer? The answer is obviously "no". In the first case there might be many investors ready to acquire an interest in the equity, whereas in the second case it might be difficult to find a purchaser at all. The rising or falling trend as manifested in the earnings of the two companies is a clear indication of the fact that the value of shares in the two companies will be very different, although technically the average profits are the same in both the companies.

Hamilton has given two beautiful examples of how simple average can be considered to be fallacious particularly when no regular trend can be identified from the past results. The first of the examples is relating to an imaginary company in which the profits for the last ten years were as follows:

<table>
<thead>
<tr>
<th>First 5 years</th>
<th>Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years</td>
<td>£</td>
</tr>
<tr>
<td>1</td>
<td>25,000</td>
</tr>
<tr>
<td>2</td>
<td>90,000</td>
</tr>
<tr>
<td>3</td>
<td>10,000</td>
</tr>
<tr>
<td>4</td>
<td>15,000</td>
</tr>
<tr>
<td>5</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>£ 30,000</strong></td>
</tr>
</tbody>
</table>
Last 5 years

<table>
<thead>
<tr>
<th>Years</th>
<th>Profits</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>10,000</td>
</tr>
<tr>
<td>7</td>
<td>55,000</td>
</tr>
<tr>
<td>8</td>
<td>15,000</td>
</tr>
<tr>
<td>9</td>
<td>20,000</td>
</tr>
<tr>
<td>10</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Average = \( \frac{10,000 + 55,000 + 15,000 + 20,000 + 50,000}{5} = \£ 30,000 \)

Hamilton made the following comments:

"... the average of the whole of the ten years is £ 30,000. However, it will be noticed that out of the ten years only three years show a profit of over £ 30,000, and seven of under £ 30,000. It could reasonably be argued that the average lies between £ 16,000 and £ 19,000, as the profits for five of the ten years are below £ 16,000 and for the other five they are over £ 19,000." The second example relates to a cricket player whose scores in nine innings were 0, 2, 81, 7, 40, 13, 82, 1, 64. Hamilton stated -
"It would be an optimistic hazard that in his next innings he would make 30, which is commonly called his 'average'.”

3. **Markedly rising or falling profits:**

Where the profits over the last five or six years have recorded a rising or falling trend in a marked manner, it will be better to attach more importance to the last year's profits and least importance to the first year's profits. The reason behind this approach is that conditions in, say, 1983 are more likely to be analogous to those in 1982 than in 1972. This important aspect will be duly considered only when weighted average of profits is ascertained. Moreover, simple average utterly fails to take into account the trend in earnings in case of markedly rising or falling profits. Two Canadian accounting and taxation experts, Geo. ovens and Donald I. Beach, in the book, "Business and Securities Valuation" stated -

"The use of a weighted average may be a more appropriate method to measure earnings on a long-term upward or downward trend. The weighted average method gives more substance to performance in recent years and less to that of earlier years,"

The mechanism of weighted average is simple. Each year's profits are assigned a weight, - the highest weight is given to the profits
of the most recent year while the lowest weight is attached to the profits of the earliest year. The profits are multiplied by the weights, the sum of the products obtained by the process of multiplication is ascertained and thereafter the total of the products is divided by the total number of weights to get the desired weighted average of the profits concerned. If profits for (say) 5 years are taken for averaging, the first year may be assigned a weight of one, the next year of two and so on as shown below.

<table>
<thead>
<tr>
<th>Company   = X, Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(Weighted average)</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year</th>
<th>Profits (Rs)</th>
<th>Weights</th>
<th>Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>30,000</td>
<td>1</td>
<td>30,000</td>
</tr>
<tr>
<td>2</td>
<td>40,000</td>
<td>2</td>
<td>80,000</td>
</tr>
<tr>
<td>3</td>
<td>35,000</td>
<td>3</td>
<td>1,05,000</td>
</tr>
<tr>
<td>4</td>
<td>45,000</td>
<td>4</td>
<td>1,80,000</td>
</tr>
<tr>
<td>5</td>
<td>50,000</td>
<td>5</td>
<td>2,50,000</td>
</tr>
<tr>
<td></td>
<td><strong>2,00,000</strong></td>
<td><strong>15</strong></td>
<td><strong>6,45,000</strong></td>
</tr>
</tbody>
</table>

Weighted average = \( \frac{6,45,000}{15} \) = Rs. 43,000/-

The weighted average may be shown graphically in the following figure:
The above graph is a clear indication of how a weighted average can indicate the trend in earnings. This system is somewhat flexible in that the weightings need not be confined to 1, 2, 3, 4, 5 basis, but may be adjusted as 1, 2, 3, 5, 7, basis or 1, 3, 5, 7, 9 basis according to the facts and circumstances and the relevant background information of the particular case.

4. Profits showing a continually rising trend:

Weighted average may be appropriate in case of established industries with growth prospects. A greater weight has to be given to the recent experience. But in the case of industries having high growth potential particularly in developing economics like India or during a period of increasing inflation which upsets the forecasts based on averages, even weighted averages fail to cope with the need of the situation and a projected average has to be calculated.
In calculating projected average it is essential to consider some important factors, e.g. trend in past earnings, trend in turnover, relation between past profits and turnover, future expectations, increasing future costs, limitations to industrial growth etc.

So far as the projected average is concerned, it is difficult to suggest a mechanical process of calculation. Much depends on the evaluation of the whole situation by the valuer and on his expert opinion as to the mechanism of projection. An example is given below:

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales (in Rs.)</th>
<th>Profits (in Rs.)</th>
<th>Increase in sales (in Rs.)</th>
<th>Increase in Profits (in Rs.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5,000</td>
<td>500</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2</td>
<td>6,000</td>
<td>700</td>
<td>1,000</td>
<td>200</td>
</tr>
<tr>
<td>3</td>
<td>8,000</td>
<td>1,500</td>
<td>2,000</td>
<td>800</td>
</tr>
<tr>
<td>4</td>
<td>12,000</td>
<td>3,000</td>
<td>4,000</td>
<td>1,500</td>
</tr>
<tr>
<td>5</td>
<td>16,000</td>
<td>5,000</td>
<td>6,000</td>
<td>2,000</td>
</tr>
</tbody>
</table>
For the purpose of projection, the first two years are avoided because the first year of many new businesses is treated as the year of establishment and the second year as the year of experiment.

Increase in Profits between

3rd year and 4th year = 187%

Increase in Profits between

4th year and 5th year = 133%

Average increase during these three years = 160%

Average profits for the three years = Rs. 3,750 (weighted average).

Assuming an increase of profits @ 160% during the next three years, the average profits may be taken to be Rs. 3,750 + 160% = Rs. 6,000/-.

Percentage of increase in profits to increase in sales:

3rd year = 40%
4th year = 37.5%
5th year = 33%

There is a falling tendency of the percentages. Between 3rd year and 4th year the fall is 2.5% and between 4th year and
5th year the fall is 4.5%. The average fall may be taken to be 3.5%.

Average profits Rs. 6,000 minus average fall expected in the increase of profit as related to increase in turnover being 3.5% = (Rs. 6,000 - 3.5%) = (Rs. 6,000 - Rs. 210) = Rs. 5,790 = projected average profits. In calculating projected average care should be taken to see that the result obtained is not reduced to a more imaginary figure devoid of connection with reality.

Views of different courts and authorities on averaging:

In selecting any process of averaging it is necessary to remember that the whole purpose is to obtain some guide to assist the valuer to make a forecast of the future. In this connection it is considered useful to take note of the following comments made by distinguished authors and honourable judges.

(a) T.A. Hamilton Baynes -

(i) "..... averaging profits is only a means to an end, the end being to discover whether the past can be projected into the future",

(ii) "In recent years inflation has upset forecasts based on averages; less emphasis in Prospectuses has been given to past profits, except to indicate growth."
It is not denied that in certain circumstances it might be possible to reach a fair valuation by a theoretical calculation based on the average of Past Profits. The valuer must, however, be aware of the odd results which can be thrown up by an uncritical use of averages.\textsuperscript{\[122\]}

(b) Geo. ovens and Donald I. Beach - "Even assuming that the distant future might be predicted, it has been generally accepted by experienced valuators and by the courts that mechanical averaging methods often create only an illusion of accuracy.\textsuperscript{\[123\]}

(c) A.V. Adamson with M.G. Coorey - "In the use of average yields and average profits - or indeed any average - the greatest care is necessary to ensure that the factors averaged are truly comparable and are relevant to the result being sought.\textsuperscript{\[124\]}

(d) Williams, J. - \textsuperscript{\[125\]}

(i) Abrahams' case - The learned judge referred to the danger of taking average and said that "an examination of the evidence with respect to the companies relied upon by the witness in this case confirms to my mind, how little light such a process of averaging can throw on the true value of shares in any particular company."

(ii) Daandine Pastoral Co.Ltd. case - In this case it was necessary to ascertain the unimproved value of a land for the purpose of Land Tax Assessment Act. The value obtained by averaging the sales of five allegedly comparable properties was considered
by the court. The learned judge cautioned about the danger of indiscriminate averaging of values and stated:

"This method of averaging is to my mind unsound. The prices obtained on sales of small areas are dealt with in this way in order to obtain the value per acre of a large area. The only safe course is to compare each sale with the subject land separately. For instance, if three sales considered to be comparable of £3, £2/10/- and £2 per acre are averaged, the average value would be £2/10/- per acre. But if the subject land was closer in value to the land sold at £2 per acre than to the other lands, the average value would cause the subject land to be seriously overvalued. When such a method is applied to a large station in order to arrive at the proper value upon which to calculate a Progressive land tax it can lead to a grave injustice."

(4) Lord Fleming in Findlay's Trustees Vs. I.R.C. 127 - He was opposed to uncritical use of averages. His view was that a simple average of the profits earned ".....operates quite equitably when one is dealing with a well established business, which has normal ups and downs but has no violent fluctuations in either direction. But if there is a definite trend upwards or downwards it may be different...."

The above comments are never aimed at condemning the practice of averaging, but these were made to put the share valuers on guard when they resort to averages. The valuer must be alert
about the danger of accepting too readily the mechanical averaging methods without due consideration of their limited application.

(Y) Projection of the future maintainable profits and necessary adjustments in respect thereof:

The second fundamental step necessary to arrive at the future maintainable profits is the projection of past average earnings into the future. This is one of the most difficult jobs of the valuer because by projection what the valuer is attempting to do is certainly an estimation of the happenings of the risky and uncertain future. The burden is heavy, the responsibility is enormous and the valuer now is faced with the challenge of how judiciously he can foresee the future events so that he can effectively assimilate their effects for the refinement of the past results as a future guide. Human beings are not prophets and therefore, can not predict accurately all future events. Thus while reasonable errors of judgement may be discounted, it is imperative that the prudent valuer essentially takes into account all factors which can reasonably be expected to be known at the time of valuation. Under normal circumstances, the past average profits may be taken to operate as the average profits which can be maintained in the future. The conditions precedent are, - (i) that the future would be a continuation of the past; (ii) that the factors affecting
past results would be almost equally relevant in the future; and
(ii) that the ups and downs in the future would be normal without
any violent fluctuations for any reason whatsoever. 129

But where the Probability is that the future would depart
significantly from the past, it will be unwise to accept the past
performance without question. In such cases it is necessary to
make appropriate adjustments before accepting the past
average earnings as the
future maintainable profits. Again where
the past performance is not truly comparable with the future
because of one or more exceptional happenings expected to occur
in future, the past results are to be adjusted and modified in
the light of prospective events so that the valuer is exonerated
from the charge of an uncritical use of past results having
little or no connection with the future reality.

It is a dangerous or rather an adventurous attempt to outline
a complete list of adjustments necessary before accepting the past
average profits as the future maintainable profits. The valuer is
the appropriate authority to draw such a
list according to the need of the parti-
cular case. However, some of the important
adjustments which may be necessary are discussed below.

(a) Discontinuation of a part of the business :-

Discontinuation of a part of the business provides an occasion
Exclusion of income from discontinued part of the business.

For adjustment. Where a part of the business of a company is to be discontinued, the adjustment becomes quite easier and what the valuer is required to do is simply to exclude the amount of profits earned by such part of the business from the future maintainable profits. The problem is relating to the determination of income from the reinvestment of funds released from the discontinued part of the business. If the fund released is to be utilized in the execution of any scheme, the profitability of the scheme has to be taken into account, provided of course, the scheme appears to be feasible and profitable in the judgement of the valuer. In the absence of any profitable scheme for the utilization of the released fund from the discontinued part of the business, the valuer is at large to assume that the fund cannot, for the time being, find any employment and a reasonable amount may be taken to be the income from the unemployed fund and an adjustment may be made for the amount.

(b) Schemes of expansion

The consideration of expansion schemes presents some complex problems. Firstly, the valuer has to test the feasibility of the schemes and if the schemes appear to be practicable, he will have to apply his discreet judgement to decide the profitability of the schemes. Secondly, a plan for expansion, however feasible it may
A few problems relating to the adjustment for the schemes of expansion, be, carries little weight for the purpose of adjustment in projecting maintainable profits, if the plan exists as a mere paper work. In other words mere paper plans for expansion and development should not be taken into consideration. The state of execution of the plan at the time of valuation and the prospective step for its execution in future are the important considerations. Only where reasonable indications are available about the expected future profits, the valuer can consider such profits on a purely conservative basis so as to take care of the greater degree of risk and uncertainty associated with the expected profits and can include such profits into the future maintainable profits. Thirdly, where the future schemes are of such a nature that substantial amounts have to be spent before profits can be expected from the projects only after the lapse of some years, it is necessary to give due consideration to these important aspects. In these cases a separate value may be calculated for the required new investments. The value arrived at by capitalizing the normal maintainable profits may be increased by the said separate value. Some valuers may use the technique of discounted cash flow\textsuperscript{130} in these circumstances. The estimated future expenditure and the future earnings taken on the basis of the expectations of the management may be discounted to the present worth by applying the earnings rate\textsuperscript{131} of the company as the discounting rate. The valuer should be extremely cautious in accepting the future earnings in view of the heavy risk attached.
the view that "a change in management should be a factor for consideration in assessing value". With regard to the Clifford's case in which no regard was paid to the adjustment for the outstanding ability of the past management, Adamson stated:

"It is thought that the decision in Clifford's case applied to the particular circumstances of that business and did not establish a general precedent".

(d) Other prospective changes:

The valuer may be required to take into account the effects of such happenings as change in capital structure, change in the utilization of the productive capacity, political changes, changes in the policy of the Government regarding foreign collaboration, nationalisation or further control, changes in the industrial policy of the Govt., changes in the organisational set-up of the company, if such changes (i) appear to be material in nature, (ii) can be reasonably known in advance and (iii) can be properly quantified.

(e) Unusual items:

It has already been mentioned that items of exceptional and non-recurring nature are to be excluded in determining the average maintainable profits. At the time of elimination of these items, it is necessary for the valuer to take proper note of the following situations:
1. Due consideration may be necessary, if some non-recurring incomes or expenses are sure to be earned or incurred in future. For example relief to industries in backward areas may continue for some more years.

2. Items to be eliminated must be "sufficiently material to have a decided effect upon the results". Adamson emphatically stated :-

"Some caution should be observed in eliminating special earnings of smaller amounts or where they can not be segregated as specific sums. The calculations should not become so involved as to render them more academic than realistic".

Inflation:

There is no denial of the fact that in recent years inflation has upset the forecasts based on past average profits. Since some element of foresight is involved in the process of projection, the valuer is required to determine objectively the effects of inflation on future maintainable profits and must make adjustment which, in his opinion, are necessary for accepting past average profits as future maintainable profits of the company.

Risks and uncertainty associated with forecast:

In projecting the future maintainable profits some sort of forecasting is unavoidable. Risks and uncertainties of future are definitely associated with forecasts. Thus in making adjustments for the effects of various events in future, the valuer must
proceed on a conservative basis and must make an allowance for the risky and uncertain future.

(k) **History and prospects of the company:**

The valuer of shares should study the history of the company and of the industry. From his own experience and also from other sources of information, he may know of the industries which are developing and of others which are declining. The most important reason for investigation into the history and prospects of both the company and the industry is the necessity to form some opinion as to the future so that the projection of the future maintainable profits may be easier and effective.

In Salvesen's case and Holt's case, the courts considered the history and prospects of the company. On the basis of the study of the history and prospects of the company, the valuer may decide to make such adjustment as he may think fit for the projection of future profits.

(7) **Adjustment of preferred rights of creditors and preference shareholders.**

The third important step necessary to arrive at the future maintainable profits is to make adjustments in respect of various preferred rights. Firstly, all charges including interest on debentures and other loans are to be deducted from the past earnings.
Secondly, the question comes about the preferential claim of the preference shareholders about dividend. So far as the preference dividend is concerned it is necessary to bear in mind that it is subjected to two conditions, namely (1) availability of divisible profits; (2) terms of the issue of preference shares. Since the payment of preference dividend depends on the availability of divisible profits, it is wise to consider such dividend only after the estimation of future profits. The amount to be deducted from the estimated future profits as preference dividend is determined after a careful consideration of the terms of the issue of preference shares as embodied in the articles of association of the company. Thus if the preference shares happen to be cumulative preference shares of different types considered, any arrears of dividend payable on such shares may be spread over the future years on the basis of estimated divisible profits. For this purpose the arrears payable may even be discounted to their present worth by employing the technique of discounted cash flow. The earnings rate of the company may be taken as the rate of discounting. Again if the preference shares are participating preference shares, both the original amount of dividend calculated at the fixed rate and the maximum amount estimated to be available from the participation in the surplus profits expected to be available as dividend out of the expected future earnings should be deducted. Furthermore, in case of convertible preference shares...
it is necessary to see that period within which the conversion is to be carried out, has expired or will expire within a short time. However, since the whole purpose of carrying out the adjustment in respect of preference dividend is to arrive at maintainable profits for equity shareholders only, it is advisable to deduct the maximum preference dividend payable under the terms of the issue from the estimated maintainable profits.

(2) **The rate of capitalisation:**

After the determination of future maintainable profits, the next fundamental step involved in the method of valuation of shares on the basis of maintainable profits is the determination of the rate at which the future maintainable profits, which have been estimated after careful adjustments, are to be capitalised with a view to arriving at the total value that may be assigned to the equity shares of the company. The selection of an appropriate rate of capitalisation, as many authors commented, is by far the most difficult part of this method of valuation particularly because the attempt to determine the rate of capitalisation involves the subjective aspect of the problem. Geo. Ovens and Donald I. Beach are of the opinion that the selection is difficult "because the criteria upon which to base such a selection are not always available or understood." Yorston, Smyth and Brown have described the rate of capitalisation as the most elusive item to determine.
Sidey apprehended that there was likelihood of a serious divergence of opinion in the selection of the rate. However, the fact is that the selection of a proper rate of capitalisation is a difficult job, because generally it is influenced by too many factors and ticklish issues which are not capable of scientific calculation. Nevertheless, the choice of a proper rate has to be made, of course, with utmost care, because in the ultimate analysis, the findings of a valuer must firmly rest upon the selected rate and any small variation in the rate selected will have a substantial effect upon the value ultimately reached for the equity shares.

Because of the multiplicity of factors involved in the process of determination of the rate of capitalisation, it is not possible to lay down hard and fast rules for the selection of rate of capitalisation. The circumstances peculiar to each individual case must be considered. Yorston, Smyth and Brown have laid down the general principle of selection of the rate of capitalisation in the following words:

"Theoretically, the rate should be that return at which a willing, but not anxious, buyer would be attracted. This in turn would be governed, primarily, by the degree of security, and the state of money market at the relevant date. Therefore, the first consideration in determining the fair rate of capitalisation is the degree of security which, in turn, is ensured by the receipt of long-term risk-free interest on investment. Again, since the money market
is generally subjected to risks and uncertainties, some additional earnings must be available to the investor so that an adequate cover to the risks and uncertainties may be provided. The question of how much additional earnings are to be taken as fair has to be answered with reference to the relative degree of risk and uncertainty of a particular case. Generally speaking, where the risk is high, or where the uncertainty related to earnings is great, an investor will, no doubt, expect a high rate of additional earnings.

Two important elements of the rate of capitalisation, percentage yield from riskless securities and an additional income for risks and uncertainties.

Thus, in a company producing a commodity of highly uncertain demand, the investor will definitely insist on a high rate of return. Conversely, in Government securities or other types of relatively riskless investments, the purchaser will be satisfied with a low rate of return because of the safety factor in the investment itself. No matter, high or low, the risk factor, though sometimes obscured, is present and that is why the rate of capitalisation adopted in valuation under maintainable profits basis is considered to be consisting of the current percentage yield from a presumably riskless investment, for example, Government securities or other gilt-edged securities, increased by a further percentage which can be taken to be the proper measure of the risk factor and precisely the additional expectation of the investors for this risk factor has to be determined with reference to—\(-i\) the provision to be made for the fluctuations in profits and dividends which must
occur in any company and (ii) the extent to which recognition is necessary for the fact that the present scale of profits cannot continue in perpetuity. H.E. Seed emphasized the need for recognition of the fact that the present yield will not continue in perpetuity and stated:

"When considering the reasonable rate of yield, the risk attaching to the possibility of the retention of the high profits is taken into account in fixing this rate. When an investor purchases shares at a premium in a successful industrial concern earning large profits, he is well aware that those profits are not necessarily likely to continue indefinitely. Consequently, with this risk in mind, he will require a correspondingly higher return...... If he believed that the yield was going to arise in perpetuity he would presumably be satisfied with a rate in the neighbourhood of that on gilt-edged securities."

The additional earnings for the risk factor determined by considering the abovementioned two elements may be augmented by a small percentage for successful risk bearing as referred to by Bonbright in the following words:

"Investors are supposed to demand a premium for successful risk taking."

To sum up, the simple principle that may be followed primarily for the fixation of the rate of capitalisation is to take an
Primary Principle of fixing the rate of capitalisation. aggregate of the long-term risk-free interest rate and of an extra sum to cover the risk involved in the business. Here again it is necessary to emphasize that risks vary from business to business and it would be futile to fix a rate of capitalisation for all businesses. Even the rate fixed for one business can not be definitely declared to be the rate totally representing the whole element of risk and uncertainty associated with the trading operations of that particular business. Moreover, the factors that go to determine the risk in a particular business are extremely complicated and the measurement of them is very much a matter of judgement.

Thus for all practical purposes, the valuer is the final authority to fix the appropriate rate of capitalisation after a careful consideration of the facts and circumstances of the case under his consideration. But he normally adopts some form of composite rate which takes into consideration both the long-term risk-free expectation and the short-term earnings to cover the risks and uncertainties. For this purpose, the best course that may be pursued is to resort to what the financial experts call the earnings rate which is found out in the following manner: -

\[
\text{Composite rate for long-term and short-term expectation.} = \frac{\text{Last year's profits available for equity shareholders}}{\text{Current market price of the equity shares}} \times 100
\]

The two component elements of this earnings rate are: -
(a) Ascertainment of current market price of equity shares.

(b) Determination of last year's profits for equity shareholders.

(a) Market price for equity shares:

Market effects and necessary adjustments. Normally, the current market quotation for the equity shares has to be used.

Since the stock exchange sales and quotations are taken as the current verdicts of the market place, these act as the best available approach to the determination of market value of the shares. The only requisite condition is that the share market has to be unbiased and perfectly competitive in which the price is the result of the interaction of the forces of demand and supply. But if the market is imperfect, biased, or ill-informed (which is in fact the condition of the market in practice) the stock exchange quotations can not be taken as truly reflecting the earning capacity of the company. In fact, the stock exchange quotations are influenced by such factors as general market conditions, economic or political situations, speculations, rumours, or other extraneous factors. It is a normal scene in the stock exchange that with the approach of the time for the declaration of dividends or with the spread of the rumour that a man with high social or political standing and connections is going to join into a particular company, prices of shares run high. "In some instances, current quotations may be so affected by professional bull or bear operations, or by temporary optimism or pessimism, as to be an unreliable guide to
fair market value. Or the market may be under strong temporary selling pressure of a large seller who is obliged to quit his holding. The inadequacy of the stock exchange quotations was also referred to by the Council of the London Stock Exchange in the following statement made in December, 1946:

"We desire to state authoritatively that stock exchange quotations are not related directly to the value of a company's assets, or to the amount of its profits, ............

The Stock Exchange, whether as an institution or as a body of individual members, does not determine the prices of which the official list is a record. The Stock Exchange may be likened to a scientific recording instrument which registers, not its own actions and opinions, but the actions and opinions of private and institutional investors all over the country and, indeed, the world. These actions and opinions are the result of hope, fear, guesswork, intelligent or otherwise good or bad investment policy, and many other considerations. The quotations that result definitely do not represent a valuation of a company by reference to its assets and its earning potential.

Moreover, any valuation by reference to stock exchange quotations must introduce indefensible anomalies as between one stock and another of similar standing. A further consideration is that stock exchange quotations are moved, often materially, by the transaction of business in only a very small proportion of the total amount in issue of any given security. In this way considerable
fluctuations take place upwards or downwards at times and in circumstances when it is possible to demonstrate that no known change has taken place in the capital value or the earning potential of the underlying assets..

G.O. May also criticised the stock exchange quotations in his famous book in the following terms:

"I think that they represent the fair market value for small blocks of stocks, on the basis of my definition of fair market value as being the price which might reasonably be expected to be realized in the market in which the property would naturally be sold...."

Thus some adjustments may be necessary either to neutralize the ill-effects of anomalies or abnormalities affecting stock exchange quotations or to rectify the distortions caused to market quotations by the presence of extraneous factors. An alternative solution may be to take an average of the market quotations over a certain period of time. But here also it is necessary to remember the danger of indiscriminate averaging referred to by Williams, J. in Abrahams' case and in Daandine Pastoral Co. Ltd. Case and accordingly, in the use of average stock exchange quotation, the greatest difficulty is to ensure that the average becomes effective and relevant to the purpose.

It is necessary to suggest here that the above comments regarding the market quotations of shares and the consequent adjustments for extra-ordinary influences on stock exchange quotations are not
intended to condemn the ruling prices of shares in the market, but these are meant to put the valuer on guard when he resorts to market value of shares for the purpose of determining the earnings rate. After all market prices of shares are the reflections of open market negotiations between the buyers and sellers and are the manifestations of the willingness of the interested parties to come to an agreement about the value of some shares which are the subject of their negotiation. Stock Exchange quotations should not be generally identified as irrelevant. Thus in Murdoch's case, the learned judge stated:

"When shares in a company are being bought on the stock exchange and there are no abnormalities affecting the market, the price at which the shares are changing hands in the ordinary course of business is usually their true value."

In Myer vs. Commissioner of Taxes, Martin, J., stated:

".........market value is not a conclusive test of real value, but in most cases where there is a free market and shares or other commodities are dealt in daily and in quantity, it is very cogent evidence of the real value."

In re Louissen, deceased case, the learned judge said:

".........the market price on that day might, through a panic or some other reason, be no criterion of the real value. But as a rule the price which has been the result of what
has been called 'the chaffer of the market' is, if not an absolutely accurate test, at least the most convenient and simple. The buyers and sellers are, in fact, jurors, to whom an assessor can safely leave the decision.

With regard to the reliability of the stock exchange quotations, Adamson stated:

"Unreliable as sometimes they may be, Stock Exchange sales and quotations afford the best available approach to the determination of yield, both to establish the riskless rate applicable to gilt-edged securities and as a basis of comparison where there are stocks with characteristics sufficiently similar to the shares or business being valued."\(^{161}\)

Bonbright described the stock exchange quotations as the "current verdicts of the market-place" and decried the tendency of some people to ignore the market prices of shares. He said:

"Among certain writers on appraisal theory there is a propensity to overstate this tendency of the courts to depart from current verdicts of the market place in favour of more sensible or more enduring estimates of value."\(^{162}\)

The above comments indicate that there is no reason why stock exchange quotations should be taken lightly in all circumstances. Instead, the point to be noted is that in the absence of substantive grounds for adjustments, the stock exchange values should be viewed in their proper perspective, and should not be disturbed or
ignored or taken lightly. But if abnormalities are found or evidence of the influence of extraneous factors is available, the valuer must endeavour to measure and allow for them with the help of his own reasoning and judgements.

(b) Last year's profits for equity shareholders:

The market price of shares has a very close relation with the present and prospective profits. The companies are not always consistent in their methods of determining net profits and this is the reason why it is necessary at times to make some adjustments to the published figures of net profits before using them for the valuation of shares.

The vital point to be kept in mind is that the net profit to be used for determining the rate of capitalisation for the valuation of equity shares must be after the deduction of all expenses and necessary provisions, but before making any appropriations to reserves. Where a company has issued preference shares, the profits to be used must remain after the deduction of the claims of the preference shareholders. The earnings rate now determined for the capitalisation of maintainable profits for equity shareholders will under normal circumstances represent the return which a willing investor can expect from the company concerned. But it may be necessary, sometimes, to make an adjustment to this rate.
in order to give due consideration to the existence of one or more of the following factors which have to a direct or indirect bearing on the expectation of the Prospective investors:

1. **Period of Investment**: The longer the period of investment, the higher is the rate of expectation.

2. **Bank Rate**: Any increase in the bank rate will lead to an all-round increase in the expectation of the investors.

3. **General Economic and Political Situation**: If the general economic and political situation deteriorates and the confidence of the investors is shaken, the expectation of the investors will increase.

4. **Dividend Performance**: If the company bears a record of declaring dividends at more or less uniform rates without any default, the investors may be satisfied even with a low rate.

5. **Financial Stability**: If the company is financially strong and has maintained a uniform record of financial prudence by not allowing the whole of the profit to be drained out in the form of dividends, more investors will generally be attracted.

6. **Conservative Management**: The declaration of dividend is altogether a prerogative of the board of directors. If the board is Conservative and locks up excessive profits in the business, the incentive to the investors will be reduced.
(7) **Net assets cover**: Net assets cover has value from the point of view of safety. If the net tangible assets of the company are (say) two or three times the paid up share capital, the investors' feeling of security lowers their expectation.

(8) **Future Prospects of the company**: If the future prospects of the company are good, the investors may be happy with the present low rate of earnings.

(9) **Reputation of the Company**: Goodwill of the company attracts more investors even with low earnings.

(10) **Prospective benefits to the Shareholders**: Apart from the general business prospects referred to above, some expected future benefits may influence the investors' decision to accept the present rate of low earnings. The prospective benefits may take the form of resumption of dividend, capitalisation of reserves by issuing bonus shares, or the possibility of issuing right shares.

(11) **Financial position**: Sound financial position tends to lower the expectation of the investors.

(12) **Prevailing interest rates**: The expectations of the investors generally vary with the ruling rates of interest. In times of cheap money which predicates low rates of interest, the expectation will be less than in times of dear money which predicates high rate of interest.
(13) Effect of death of, or sale by, an influential member:

The effect of the death of, or sale by, a member with large and influential holding is an important consideration, particularly because this type of incident may affect the continuity of management and contracts of the company with outsiders. If there is a possibility that the incident will loosen the security of dividend, the expectation of the investors will be high.

(14) Threat of nationalisation: The threat of nationalisation reduces the number of investors. Those who want to have stable capital employment will not come forward.

(15) General situation in the industry: If it appears that the product of the industry is gradually becoming popular, the investors may be satisfied with low earnings for the time being.

(16) Possibility of foreign market: The possibility of entering into a foreign market brighten the prospect of the sale of the product and the expectation of the investors may be low.

(17) General trend of earnings on capital employed: The relationship of net profit to capital employed is very important. If the rate of earnings on capital employed is uniform or increasing, the feeling of security will tend to lower the investors' expectation.

So far the discussion centred round the quoted shares of companies. Now in the case of companies whose shares are not
quoted on the stock exchange, the determination of an appropriate rate of capitalisation presents a strong hurdle to be crossed. One simple solution that may be forwarded in these cases is to look for the stock exchange quotations of those quoted companies which belong to the same industry and are sufficiently comparable in almost all respects with the unquoted company whose shares are to be valued. W.A. Paton must have supported this view, and the book edited by the famous professor contained the following statement:

"In general the rate implicit in market prices of representative stocks somewhat similar to the stock being appraised is a satisfactory starting point..." 164

Selection of comparable shares quoted on the stock exchange. In Clifford's case, the Court gave recognition to the evidence from prices paid for shares in companies carrying on a similar business listed on the stock exchange.

After a careful and close analysis of the quoted companies operating in the same field as the company under consideration, the most closely comparable quoted company is selected. While making comparison among the quoted companies for the purpose of selecting the quoted company, truly comparable with the unquoted company, it is necessary to focus attention on such important points as history of the company, nature of activities, size, capital structure, managerial skills etc. The comment made by Adamson with regard to the selection of comparable shares of Companies seems pertinent here. He stated :-
"The best comparison is obtainable from stocks of companies whose activities, size, and history resemble mostly those of the business which is required to be valued."

A suggestion may be made to adopt the average of the Stock Exchange quotations of the particular industry in which the unquoted company under consideration is in operation. The suggestion, seemingly good and easy to operate, is not generally appealing and tenable because of the presence of adverse legal and expert opinions. In Abrahams' case, Williams, J. made strong qualification against indiscriminate averaging. His comment was:

"The witnesses have sought to support their opinions by reference to the average profit and dividend yield upon the prices paid for shares in companies registered on the Melbourne Stock Exchange in October, 1938. In both Murdoch's and K.C. Cathie's cases I pointed out the danger of taking such averages except as a very remote background to an investigation..." 

The opinions of Adamson and H.E. Seed, although as regards the average yield from shares in a particular industry, may be shown as an eye-opener to the danger of averaging. Adamson wrote:

"

His two other comments about averaging deserve mention here.
"The average yield from quoted stocks in a particular industry is not reliable as the basic rate of capitalisation." 168(ii)

"It is suggested that these comments do not condemn the practice of averaging in itself, but they do stress the great difficulty of obtaining units which are sufficiently comparable in all respects to be capable of average. Most fantastic results can be obtained by attempting to average certain items or figures which are not truly comparable." 168(iii).

H.E. Seed did not think it advisable to adopt a "rough average of the rates disclosed by the market values." 169

The fact is that no two companies, even within the same industry, are of the same characteristics. Differences are bound to be there. Market quotations of different companies operating in the same industry are affected by different factors. Thus instead of attempting to average stock exchange quotations of the quoted companies, operating in the same field as the unquoted Company under consideration, it is advisable to select the most closely comparable quoted company whose market quotations after appropriate adjustments may be adopted for determining the earnings rate that may be accepted as an aid to the fixation of the appropriate rate of capitalisation for the unquoted company.

Adjustments to the stock exchange quotations referred to above are necessary because it is difficult to find any quoted
company, which is in all respects comparable with the unquoted company whose shares are being valued.

The purpose of the adjustments is to make provision for the differences that exist between the selected quoted company and the unquoted company under consideration. The normal adjustments that may be necessary relate to the following matters:

(a) Non-marketability of shares of an unquoted company.
(b) Differences in the size and standing of the business.
(c) Differences in Capital structure.
(d) Net tangible assets backing for the companies.
(e) Difference in the managerial set-up.
(f) Trend of Profits.
(g) Amount of working capital and ratio of liabilities thereto.
(h) Difference in activities.
(i) Uncalled liability on shares.

Non-marketability of shares:

Non-quotation on a stock exchange is a disability attached to the shares. Lack of negotiability definitely restricts the number of "willing buyers" and tends to lower down the price of the shares. Since no wider market is available for the shares because of the absence of stock exchange dealings, the prospective investor will naturally expect a higher return on his investment in order to compensate him for the lack of negotiability due to non-quotation. It is quite natural for a "willing buyer" to look forward and to take cognizance of the restricted market for the shares. Thus the judicial view is in favour of adoption of a higher return on investment for the lack of negotiability. Of
course, there is a difference of opinion about the extent of adjustment necessary for the lack of marketability due to non-quotation.

(b) Difference in the size and standing of the business:

Investors are normally ready to accept a lower return on their investment in the case of an old established business with widespread functions and a good record of Progress.

It is difficult to find two businesses of the same size and standing. Therefore, an adjustment is necessary for the difference between the two companies in respect of size and standing.

(c) Differences in Capital structure:

Differences in Capital structure arise because there is no such thing as the model capital structure for all business undertakings. Though every company endeavours to attain a proper balance between owned capital and borrowed capital, there can be no denial of the fact that any decision for evolving a capital structure is normally made only within the context of the individual company at a particular stage in its history. An adjustment may be necessary to take cognizance of the effects of improperly balanced capital structure on the earnings and dividend prospects which constitute a major consideration in determining the value of shares.
(d) **Net tangible assets backing:**

The valuer should take great care in making adjustment for variation in net tangible assets backing. Normally, an adjustment is necessary on this account in cases where a substantial variation from the shares of the company, selected for comparison, is noticed. But it is necessary to exercise great caution in advocating any lower return for an apparently higher asset backing or any higher return for an apparently lower net assets backing, because of the fact that a higher net assets backing may imply that total economic use of the assets is not being done or that the assets are not very much effective or that the assets were purchased at a high price and a lower net assets backing may signify that the assets were being used more efficiently or that these were purchased at an economical rate. However, in making a comparison of net tangible assets, the notable point is that only those assets which are used in the production of the maintainable profits should be considered.

(e) **Difference in managerial set-up:**

An adjustment may be necessary for any variation in earnings caused by difference in the quality and efficiency of management. The energy and aggressiveness of one or two key men in the managerial set-up may create the whole difference. While good management tends to reduce an investor's expectation, bad management calls for an adjustment for higher return on investment.
(f) **Trend of Profits:**

An adjustment may be necessary for the upward or downward trend of profits. If the valuer is satisfied that the trend is encouraging, he would be justified in lowering the rate of capitalisation. Conversely, if the trend of earnings is at its low ebb the valuer may enhance the rate of capitalisation. At the same time it is necessary to add that an adjustment on this account is necessary only when the valuer is assured of the continuation of the upward or downward trend for a long period of time.

(g) **Working Capital and ratio of liabilities there-to:**

The amount of working capital and the proportion of priority claims there-to are important considerations for an adjustment. If a company has sufficient working capital of its own and the danger of foreclosure by an outsider is negligible, an investor is not likely to demand a high percentage of return. Conversely, risks run high in the case of a heavy dose of priority capital and external finances and an investor any demand an adequate compensation by way of increase in the rate of return on investment.

(h) **Difference in the activities:**

Adjustments should be made for the difference between the two companies arising out of competition, nature of commodities dealt in, volume of transactions, protection by patents and trade marks, size of market etc. Normally, an adjustment under the above heading is not necessary, because a comparable quoted company is selected with the greatest similarity in the nature of activities or commodity dealt in. But it does not mean that no adjustment should be
made even in case of the presence of any difference in the nature of activities or commodities dealt in.

(1) **Uncalled liability on shares**:

An adjustment may be necessary to give recognition to the possible disability of holding party paid shares in an unquoted company. This is very important because the existence of uncalled liability on shares particularly in a weak company or even in a company which may not require the uncalled capital in the near future implies an additional risk for which the investor may seek additional cover. Adjustment may also be necessary to take into consideration the difference in the incidence of taxation, the effects of extraneous items and many other factors peculiar to a particular company.

With regard to these adjustments, it will be prudent to add that the valuer has a great role in deciding on the adjustments necessary for a particular case. He is also the sole authority to assess the amount of each adjustment according to the facts and circumstances of that particular case. In this connection the following comment of Adamson appears to be relevant:

"No precise scale of adjustments can be tabulated as the differences vary so much in character and degree between various businesses. A practical business approach should be made to gauge the effect of each difference upon the outlook of willing and informed buyers and sellers."
A difficult situation arises where it is not possible to find out a quoted company which is sufficiently comparable with an unquoted company. Sometimes it may so happen that a closely comparable quoted company is available. But its shares are not actively dealt in, so that current market quotations are not available. Where the shares are not actively traded, the "only indication of present value" in the opinion of Adamson, "will be buying and selling bids or perhaps one of these only". 172 The trend of bids before and after the actual date should be traced to see if it is possible to arrive at a probable point at which buyers and sellers should meet." 172 Frankly speaking, in all these circumstances, with no clue generally left out to the valuer to untie the knot, he will have to take recourse to his good reasoning and judgment for the determination of the rate of capitalisation. Of course, he will base his judgment on a careful consideration of various important factors, e.g. nature and size of the business, history of the company, trend of profits, assets cover for the investments in the company, fluctuations in profits, risk factor etc.

Sometimes problems arise in the fixation of the rate of capitalisation for a company which carries on two or more very distinct units of business. In such cases the best possible step is to determine the maintainable profits separately for the two units of business and to apply the rate of capitalisation appropriate to the individual unit of the business. If this course of action is not possible, the valuer may apply his own reasoning
and judgement to arrive at the rate of capitalisation for this type of companies.

It is admitted by all concerned that the factors that go to determine the risk in a particular company are very much complicated and weighing of them for the purpose of determining the rate of capitalisation appropriate to risk is undoubtedly a matter of judgement. But at the same time there is no escape from the fact that a small variation in the rate of capitalisation causes a substantial change in the final valuation figure.

Thus for practical purposes, the financial analysts and valuers often classify the industries by groups and develop rules of thumb for determining the appropriate rates of capitalisation. The rule of thumb approach to the fixation of the capitalisation rate is, of course, untenable on theoretical basis.

One important issue in connection with the fixation of the rate of capitalisation relates to the distinction which is at times made between the earnings rate of capitalisation and the dividend rate of capitalisation. It is argued that the shareholders derive immediate benefit from the Company only to the extent of the profits distributed as dividend. The benefit to the shareholders in respect of the profits retained in the business is necessarily deferred and is not available within a short period of time. The investors being subjected to less risk and to quick returns, the rate of capitalisation applicable to the distributed profits should normally be lower than the rate of capitalisation appropriate to the retained profits. The distinction made between the retained profits and the
distributed profits leads to the need for using two different capitalisation rates, - one for the retained profits and the other for the distributed profits. This distinction may be relevant in the short-run. From a long-term point of view, this distinction is of very little use, because the valuer is more interested in the present worth of the total future dividend payable and accordingly, there should be no objection to the retention of a reasonable sum of profits for the purpose of investing to earn extra profits at the normal rate of the company. Thus from a long-term point of view, the computation of a reasonable amount of maintainable profits and the use of one appropriate rate for its capitalisation will create absolutely no problem, provided the pay-out ratio is reasonable and the amount retained is properly utilized for maintenance, expansion and development and also for providing against the unknown future contingencies.

Fixation of the values of equity shares.

Now that the future maintainable profits have been estimated and the rate at which such future maintainable profits are to be capitalised has been determined, it should be possible to compute the value of an equity share by dividing the capitalised value of the estimated future maintainable profits by the number of equity shares in the following manner:

\[
\frac{100 \times \text{Maintainable Profits}}{\text{Rate of capitalisation} \times \text{Number of Equity shares}}
\]
If a company has only one type of equity shares the value as determined above will hold good. But if a company has equity shares paid up to varying amounts, the calculation of the value of a share is not quite so simple. So far as the partly paid equity shares are concerned, there may exist differing sets of circumstances which will have dominant influence not only on the value of the partly paid shares but also on the value of the fully paid shares. Thus if a company has different types of equity shares, having different paid-up amounts, but having other equal rights, then the capitalised value of the maintainable profits may be divided among the partly paid-up shares in proportion to their paid-up values for the purpose of finding out the value of a share. Again partly paid-up shares may or may not be likely to be paid-up in the near future. But since the theoretical exercises relating to the valuation of partly-paid shares do not have much application in actual cases, a detailed discussion is being avoided.

The valuer must apply his reasonable mind to the facts and circumstances of each individual case to decide upon the adjustments necessary in calculating the values of fully paid and partly paid shares including the adjustment necessary for discount on partly paid shares to give recognition to the disability of holding shares subject to a contingent liability for uncalled portion of share capital.
A Critical review of the maintainable profits basis of valuation.

The basic validity of the method so far discussed is hardly challenged because the method is based on the sound philosophy that the value of a property normally depends on the income which it can earn over the years. The method represents a pragmatic approach to the valuation of shares, upholds the sound principles of valuation and has already obtained the approval of the Supreme Court in Mahadeo Jalan's case. Instances of the methods of valuation as the one already discussed, which look into the ins and outs of the subject matter of valuation are only few and far between.

However, these comments do not bear the testimony that the above method is without any flaws and it can be applied to govern every valuation decision. This is because two basic steps involved with the method namely determination of maintainable profits and the fixation of the rate of capitalisation are subjected to so many influences and factors that are really incapable of precise measurement and logical synthesis because in the process of evaluation of the effects of these factors, there always remains a greater scope of subjective judgements and individual opinions of the valuers which can never be free from criticisms and are in almost all cases liable to bow before superior individual judgement.

Before concluding discussion on the maintainable profits basis of valuation of shares, it will be beneficial to have a discussion on some other valuation approaches related to profits which are at times used for the valuation of shares. The most remarkable of these approaches are :-

-
(1) **Yield basis.**

(2) **Dividend basis.**

(3) **Earnings per share (EPS) basis.**

---

(i) **Yield basis:**

Yield as distinguished from earning capacity which represents the whole of the profits which a company can expect to maintain, signifies the amount of expected profit remaining after settling aside a reasonable portion of profits for reserves. In the words of Adamson, *Yield* may be considered to be analogous to the expected dividends.

The supporters of this method are of the opinion that an investment is made with an expectation of a recurring income. An investor wants to have an annual return, great or small, stable or fluctuating, on his outlay. The yield basis is considered to be the most useful method which can take proper care of the hopes and aspirations of an investor.

Under this method, the value of an equity share is calculated in the following manner:

\[
\text{Expected rate of return on investment} \times 100
\]

**Formula for the method:**

\[
\frac{\text{Yield (Expected Profit less reserves available for equity shareholders)}}{\text{No. of equity shares}}
\]

The yield is taken to be the balance of maintainable profits available for the equity shareholders after allocating a reasonable portion to reserves. The expected rate of return is the minimum yearly return which an investor requires or expects on his investment in a company. This minimum expectation, generally consists of three elements:
Component elements of general expectation.

1. Pure interest, i.e. risk-free interest which can be earned by investing in (say) government securities.
2. General business risk, a margin or a return to cover the risks ordinarily attached to any business.
3. Particular business risk, a return to cover the risks attached to the finances of the particular business.

The expected rate of return on investment is not a static figure, but varies considerably at different times according to changing circumstances. The following are some of the important factors affecting the expectation of the investors:

1. Degree of risks involved.
2. Ruling rates of interest.
3. Period of investment.
4. Position and profitability of the undertaking.
5. General economic and political situation.

Normally the principles which are followed in fixing the rate of capitalisation under the maintainable profits basis may be followed in calculating the rate of expectation for the investors. The following formulae may be helpful for companies whose shares are quoted on the stock exchange:

\[ \frac{\text{Last Year's profits after taxation and reasonable reserves}}{\text{Market value} \times \text{Number of shares}} \times 100 \]
Since situations vary from company to company or from time to time within the same company, the rate of expectation has to be finalised after a careful consideration of the above-noted factors affecting the yield required and if necessary, adjustment must be made in the light of the facts and circumstances of a particular case.

This method is apparently very simple and effective because it takes into account the expected dividend which an investor may aspire to receive. But the method definitely ignores the earning capacity which is more than mere expected dividend and which is considered to be the pivotal factor for the valuation of shares.

(ii) Dividend basis:

It is said that the investors are interested in the income actually received from the Company and hence the price they will be prepared to pay will depend upon the amount of dividend declared and expected to be declared by a Company. It is also said that a prospective investor takes more interest in the actual amount of profits expected to be available as dividend rather than in the total amount of profits available to a Company for the simple reason that unless declared as dividend, he can have no direct claim over the available profits of a Company in which the declaration of dividend is the prerogative of the directors whose administrative high-handedness may, at times, undermine the cherished hope of an investor to receive a regular dividend.
The formula for calculating the value of equity shares under the above method is as follows:

\[
\text{Determination of the value of shares} = \frac{\text{Dividend available or Amount of profit expected to be declared as a divided}}{\text{Expected or Required rate of dividend} \times 100} \times \frac{\text{Number of shares}}{\text{Number of shares}}
\]

In calculating the amount of profit that may be available as dividend, it is necessary to deduct from the maintainable profits the following:

1. Appropriate Provision for taxation.
2. Transfers to reserves.
3. Transfers to funds including debenture redemption found.

The minimum yearly dividend expected by an investor in the Company concerned may be calculated in the following manner:

\[
\text{Last Year's actual dividend} \times 100 = \frac{\text{Market value} \times \text{Number of shares}}{\text{Number of shares}}
\]

The rate of required dividend may have to be adjusted to take into account the changing situation of the Company. Sometimes the valuer may be required to apply his judgement in determining the expected rate of dividend.

The method, no doubt, looks after the practical aspect of the investors' Psychology. But this basis of valuation will always put a critical review a premium on the shares of companies which distribute a larger part of their profits as dividend. This can not be taken as a satisfactory situation since
it seems to reward the lack of prudence on the part of the company. Moreover, the accumulated profits may, sooner or later, be available in the form of (say) bonus shares. Thus the valuation is likely to be based on the earnings of the company rather than the dividend.

(iii) Earnings per share (EPS):

This basis of valuation considered to be one of the most modern techniques used for valuing shares in the U.S.A. can be profitably used in India. In view of its growing popularity as a method of valuation, it is considered necessary to discuss this method in some details.

Kohler's Dictionary for Accountants defines EPS in the following words:

"Net income divided by the average number of shares of common stock outstanding during the year or, perhaps more correctly, where the character and volume of the business has not changed during the year as the result of Common shares issued or retired, the number of shares outstanding at the year end. A second "earnings per share" may be appended in which shares outstanding would be increased by the shares that may be issued under convertible securities, Options, and warrants."

Ezra Solomon and J.J. Pringle, two eminent authors, have defined EPS in the following words:

EPS is PAT (Profit after taxation) divided by the number of shares of stock outstanding.
Davidson and Reil in their treatise on Accounting expressed EPS in the following manner:

\[
\frac{\text{Net income}}{\text{Average number of shares outstanding}}
\]

Thus in simple terms, EPS is the net profit after tax divided by the number of shares. In calculating EPS in practice, the average share capital is often used by the valuer.

Since EPS is interpreted as earnings per share available to the equity shareholders, it is necessary to subtract any preferred dividend requirement from the total earnings before determining the net income for equity shareholders.

The purpose of computation of EPS statistic is two-fold, namely:

1. Attribution of the earnings of an equity for a period to the various elements of its capitalization structure, based on their legal or economic relationships, preferences, and privileges.

2. Reflection of any significant change in the capitalization structure during the period for which the EPS is being computed.

Before proceeding to the evaluation of shares by means of EPS statistic, it will be beneficial to have a glimpse into the uses and limitations of EPS data. The uses of EPS are the following:
Uses of EPS

1. For comparing the operating results of business entities. Such comparison is possible either of the same entity over two or more periods of time, or between two or more entities.

2. For comparing the EPS statistic with dividend paid to obtain information about proportion of earnings of the entity retained for expansion and other corporate uses.

3. For the evaluation of the equity shares.

Limitations of EPS are:

1. EPS fails to disclose significant changes in the nature of the business.

2. EPS does not usually represent the amount available for dividend to the equity shareholders.

3. An increase in EPS may not result in a corresponding increase in the market value of shares. Many other factors influence the market value.

4. EPS is uncertain because EBIT (Earnings before interest and taxes) is normally uncertain. This creates problems in making managerial decisions.

5. The per share statistic fails to indicate the significant changes in operating ratios.

Computation of EPS:

The earnings per share statistic has to be computed with due consideration of the facts and circumstances of the company concerned. The valuer should be particularly careful about the nature of Capital Structure in Computing EPS.
Simple Capital structure:

Where only equity shares are outstanding the EPS is computed as follows:

\[
\frac{\text{Net income}}{\text{Shares outstanding}}
\]

When shares outstanding fluctuate during the period under review, as a result of the issue of shares for cash or other considerations, an averaging technique may be employed to depict sufficiently the portions of the year during which the shares were outstanding. An illustration follows.

Shares outstanding on 1.1.1982 = 5,00,000.

Shares issued for cash on 30.6.1982 = 4,00,000.

The number of shares to be used in computing EPS for the year 1982 would be 7,00,000 shares. The weighting is based on the respective time periods involved.

There is an exception to the general rule that increase or reduction in outstanding equity shares are weighted on the basis of the time of occurrence. The exception applies when changes in the capital structure are merely in form and not in substance. Thus where there is an issue of additional shares in case of sub-division of shares or the reduction of outstanding shares through consolidation of shares there are no proceeds or other considerations involved; there is merely a change in the aggregate number of shares outstanding without any change in the aggregate amount of capital. Accordingly, changes of this nature in the number of shares outstanding...
or rather the increase or decrease in the equity shares outstanding as a result of these transactions are reflected for the entire period without weighting. Another instance where no weighting is warranted may be given and this is where a company issues bonus shares.

Complex Capital structures:

Various problems are associated with the calculation of EPS in the case of a complex capital structure. It would be rather adventurous to try to outline each and every problem which a valuer may encounter in practice. Instead it is considered wise to discuss some of the problems relating to the complex capital structure.

(a) Existence of preference shares:

In the case of the existence of Preference shares, the EPS for the ordinary shares will be as follows:

\[
\text{EPS when preference shares are in existence} = \frac{\text{Net income after dividend required for the preference shares}}{\text{Equity shares outstanding} + \text{Preference shares outstanding}}
\]

The claims of the Preference shares may require adjustment because of redemption of some preference shares, conversion, or issue of additional preference shares.

(b) Effect of Potential dilution on EPS:

Dilution signifies the reduction in EPS required by the Prospective issue of new shares as per the agreements which may be attached to securities issued. It is necessary that the investor or potential investors obtain some
information about the effect of additional shares required to be issued as per agreement attached to certain securities on the EPS.

It is customary to ascertain the potential dilution in terms of the current level of earnings. This approach facilitates the comparison of the normal earnings per share for the period under consideration with the potentially diluted earnings per share on the assumption that the additional shares have been issued during the same period. In fact the potential dilution is equal to the difference between the normal EPS and the potentially diluted EPS at the current earnings level.

Thus in case of convertible debentures or preferences shares, it is assumed that the conversion has taken place at the beginning of the period under consideration. In computing diluted EPS, the interest on debentures or preference dividend, as the case may be, is disregarded and net income for the ordinary shares is accordingly adjusted. The following formula may be adopted:

\[
\text{Net income as adjusted} = \frac{\text{Net income}}{\text{Equity shares outstanding plus number of equity shares assumed to have been issued as a result of the conversion of debentures or preference shares}}
\]

A critical review of the method of valuation based on EPS:

The EPS statistic used in the valuation of shares is very simple, informative and generally all inclusive technique for a financial analyst. But the data because of the effect of a number of variables involved and because of various internal and external factors which impinge on the statistic, may take the appearance of being deceptive so that experienced investors may have reservation.
Now that the discussion has covered the various approaches related to earnings, used for the valuation of shares, it would be interesting to have a comparative study of these approaches with reference to some criteria normally applied to test the quality of a method of valuation of shares.

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Maintainable Profits basis</th>
<th>Yield basis</th>
<th>Dividend basis</th>
<th>EPS basis</th>
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<tr>
<td>1. Simplicity and understandability.</td>
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<tr>
<td>i) Simple to operate</td>
<td>Same as (A)</td>
<td>Same as (A)</td>
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<tr>
<td>ii) Easy to understand</td>
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<td>2. Purposefulness</td>
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<tr>
<td>i) Takes into account the expectations of investors</td>
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<td>ii) Considers earning capacity of the Company</td>
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<tr>
<td>iii) Computed value becomes meaningful and purposeful</td>
<td>i) Fails to consider the whole of the investors' aspirations e.g. no consideration is given to the fact that the benefit of reserves may be available to the shareholders in the form of (say) bonus shares.</td>
<td>i) To value shares on this basis is to take a narrower view of the value of a company and as such value becomes meaningful.</td>
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<td>3. Whether informative or not</td>
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<tr>
<td>i) Highly informative</td>
<td>i) Informative</td>
<td>i) Less informative</td>
<td>i) Informative</td>
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<tr>
<td>4. Inclusiveness</td>
<td>i) Considers a number of factors</td>
<td>i) Fails to consider inclusive some variables at all.</td>
<td>i) Generally all inclusive but consideration of one period only puts a limitation to</td>
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</tr>
<tr>
<td>ii) Takes into account as many variables as possible</td>
<td></td>
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</tr>
</tbody>
</table>
Criteria
Maintainable (A)
Profits basis
Yield (B)
Dividend (C)
APS (D)

(iii) based on sound principles of valuation.

5. Application
(i) can be applied for practical valuation. (A)
(ii) same as (A)
(iii) not generally applied in the USA, not in India.

6. Legal sanction
(i) no legal barrier (A)
(ii) same as (A)
(iii) same as (A)

The above study implies that the maintainable Profits basis has an edge over other approaches of valuation based on earnings. But this is not to claim that the method is the best of all methods. It is a sincere and honest recognition of the inherent dualities of the method. In fact, all these approaches based on earnings are not mutually exclusive approaches, rather these appear to look like different roots of the same tree. Therefore, in making valuation there is the least scope for being dogmatic about a particular method. A method which is best suited to a particular situation should be adopted. Even two or more methods may be tested, when it appears that a method standing alone can not serve the purpose. This practice is allowed even in the USA where APS basis is widely used, but the experienced investors, at times, feel uneasy to use the "statistic standing alone." Since the whole purpose is to ascertain the profit earning capacity of the company as accurately as possible, and since the methods based on earnings are not mutually exclusive, more than one method may be employed for the determination of the value of share's in a particular situ-
Some adjustments may be carried out to settle a proper value for shares after giving due consideration to the differing results of valuation obtained under two methods. Thus in Mahadeo Jalan's case the Supreme Court rightly said the following:

" .......... In other words, the profits which the company has been making and should be making will ordinarily determine the value. The dividend and earning method or yield method are not mutually exclusive; both should help in ascertaining the profit earning capacity ...... If the results of the two methods differ, an intermediate figure may have to be computed by adjustment of unreasonable expenses and adopting a reasonable proportion of profits ....... "
5. The Companies Act, 1956 has not defined a sole selling agent. The term may include an individual, firm or company who are or which is given exclusive rights to sell in a particular area the goods of the company concerned. Sec. 294 of the Companies Act regulates the appointment and terms of a sole selling agency.
6. The Accountant (Great Britain), 17th June, 1933.

15. Omitted.


Maintain :- "To continue in, Preserve, retain (a condition, Position, attitude etc. ..... To preserve unimpaired (a cause, right, state of things etc.) .... "


26. (i) F.H. Knight, - Risk, Uncertainty and profit (Published 1971, Printed in the U.S.A.) (Originally Published in 1921) PP. 37-38.

"Dynamic changes give rise to a peculiar form of income only in so far as the changes and their consequences are unpredictable in character. It cannot, then, be change, which is the cause of Profit, since if the law of the change is known, as in fact is largely the case, no profits can arise ........... For a satisfactory explanation of profit we seem to be thrown back from the "dynamic" theory to the Uncertainty of the Future, ......."

(ii) (a) F.B. Hawley, - Enterprise and the Productive Process(1907) PP. 106 - 107.

"..........the Profit of an undertaking, or the residue of the Product after the claims of land, capital, and labor (furnished by others or by the undertaker himself) are satisfied, is not the reward of management or co-ordination, but of the risks and responsibilities that the undertaker..... .... subjects himself to .........."

(b) J.B. CLARK, - The Distribution of Wealth (1900), - PP.404-410.

Profits are the result exclusively of dynamic change. "The type of dynamic change is invention." "An invention makes it possible to produce something more cheaply. It first gives a Profit to entrepreneurs and then .......... adds something to wages and interest .......... Let another invention be made......... It also creates a Profit; .........." (Quoted by
That the factor of change is fundamental in bringing Profits into existence was stressed by Professors Stonier and Hague."

27. B.S. Keirstead, --- Capital, Interest and Profits (1959), P.6. "Profits may come to exist as a result of monopoly or monopsony, as a reward for innovation, as a reward for the correct estimate of uncertain factors, either particular to the industry or general to the whole economy."

28. "The normal return on money capital invested by the entrepreneur and the wages or salary for his services and the money rewards for the other factors the entrepreneur himself owns and employs them in the firm are known as implicit costs or imputed costs." (H.L.Ahuja, - Advanced Economic Theory (4th Edition,1977), - P.353.


33. The Companies Act, 1956 (1 of 1956), - Govt. of India, Ministry of Law, Justice and Company Affairs. Sec. 205(1).

"No dividend shall be declared or paid by a company for any financial year except out of the Profits of the Company for that year."

"No dividend shall be declared or paid by a company for any financial year except out of the Profits of the Company for that year.

(P.E. Knight, - Ibid 26(1) - PP. 32-34 and PP.41-42).
There is nothing at all in the Act about how dividends are to be paid, nor how profits are to be reckoned; all that is left and very judiciously and properly left to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into capital account, what into an income account, is left to men of business.


37. Ibid 36, - P. 112.

38. Daandine Pastoral Co. Ltd., Vs. Federal Commissioner of Taxation - reported in "The Valuer" October, 1943, P. 303. Mr. Justice Williams stated:

"This method of averaging is to my mind unsound. The prices obtained on sales of small areas are dealt with in this way in order to obtain the value per acre of a large area ................ when such a method is applied to a large station in order to arrive at the proper value upon which to calculate a Progressive land tax it can lead to a grave injustice."


40. Geo. Ovens and Donald I. Beath, - Business and Securities Valuation (1972) (Methuen Publications), P.47.
41. R.L. Sidey, - The Valuation of shares (1950), P.16


43. Ibid 41, - P. 16.

44. Mc Cathie Vs. Federal Commissioner of Taxation, (1944) 69 C.L.R.

45. Commissioner of Stamp Duties Vs. Haynes, 1924 N.Z.L.R. 337

The learned judge observed:

"............ in attempting to ascertain .......... normal earning capacity .......... results of an exceptionally bad year cannot fairly be taken into account."


50. H.E.Seed, - Goodwill as a Business Asset (1937).

51. Ibid 50, - P. 119.


54. Ibid 40, - P. 47
Sub-Section (2) of Sec. 205 of the Act lays down the following methods of calculating depreciation:

(a) to the extent specified in Section 350; or
(b) in respect of each item of depreciable asset, for such an amount as it arrived at by dividing ninety-five per cent of the original cost thereof to the Company by the Specified period in respect of such asset; or
(c) On any other basis approved by the Central Government which has the effect of writing off by way of depreciation ninety-five per cent of the original cost to the Company of each such depreciable asset on the expiry of the specified period; or
(d) as regards any other depreciable asset for which no
rate of depreciation has been laid down by the Indian Income-Tax Act, 1922 or the rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the official Gazette or by any Special Order in any particular case:

Provided that where depreciation is provided for in the manner laid down in clause (b) or clause (c), there in the event of the depreciable asset being sold, discarded, demolished or destroyed the written down value thereof at the end of the financial year in which the asset is sold, discarded, demolished or destroyed, shall be written off in accordance with the Provision to Section 350.

69. The Companies Act, 1956 (1 of 1956), - Sec. 205
70. Ibid 36, - P. 114.
72. Ibid 41, - P. 18.
73. Ibid 36, - P. 117.
74. Ibid 42, - P. 17.
75. The Companies Act, 1956 (1 of 1956), - (i) Sec. 309 read with Sec. 198 (Overall maximum managerial remuneration and managerial remuneration in case of absence or inadequacy of profits) for remuneration of directors; (ii) Sec. 310 and Sec. 311 for increase in remuneration of directors and managing Director; (iii) Sec. 387 for remuneration of managers; (iv). Sec. 637 AA relating to the Power of Central Government to fix a limit with regard to remuneration of directors etc.
76. The Companies Act, 1956 (1 of 1956), Sec. 397 and Sec. 398 relating to application to court for relief in cases of oppression and mismanagement.

77. The Companies Act, 1956 (1 of 1956), (Schedule VI, Part I. Form of balance-sheet). In regard to Sundry Debtors Particulars to be given separately of (a) debts considered good and in respect of which the company is fully secured; (b) debts considered good for which the company holds no security other than the debtors' personal security; and (c) debts considered doubtful or bad.

78. Ibid 36, P. 123.


84. The Companies Act, 1956 (1 of 1956). Under Sec. 211(2) every profit and loss account of a company must comply with the requirements of Part II of Schedule VI, so far as they are applicable.
85. The Companies Act, 1956 (1 of 1956). Under Schedule VI, Part I (form of balance sheet of companies) provision for taxation has to be displayed separately under the head "Provisions".

86. Ibid 42, - p. 18.


i) Investment allowance - Sec. 32A (effective from April 1, 1976).

ii) Development rebate/allowance - Sec. 33 (Development rebate ceased to have effect from the assessment year, 1975-76).

Development allowance u/s. 33A allowed for tea business with effect from 1.4.1965.

iii) Rebate on export turnover - Sec. 89A inserted by Finance Act, 1982 having effect from June 1, 1982. The benefit is available only to Indian Companies and not to foreign companies. An "Indian company" has been defined u/s. 2(26) of the Income Tax Act.

88. iv) Relief to new industrial undertakings or hotels or new ships - Sec. 80J (operative for new industrial undertakings, business of a new hotel or a new ship which started operations not later than March 31, 1981).

For undertakings Commencing operations after March 31, 1981, a new scheme u/s. 80 - I, is in operation.

v) Relief to industrial undertakings in some special cases - a) Sec. 10A (Undertakings in Free Trade Zones).
(b) Sec. 80 ITH (Undertakings in backward areas) - The Section inserted by the Direct Taxes (Amendment) Act, 1974 came into effect from April, 1, 1974.

(c) Sec. 80 HHA (Small Scale undertakings in rural areas) - Sec. 80 HHA was inserted by the Finance (No.2) Act, 1977 having effect from the assessment year 1978-79.

(vi) Relief for accumulated losses - Various sections of the Income-Tax Act, 1961 provide for carry forward and set off of business losses. Such provisions are given in sec. 70, sec. 71, sec. 72, sec. 72A, Sec. 73, Sec. 74, and Sec. 79.

88. The Companies (Profits) Surtax Act, 1964 - Under the Act a company is liable to pay surtax on its chargeable profits as reduced by the amount of "statutory deduction".


90. Ibid 89, - P. 119.

91. Ibid 89, - P. 120.

92. Ibid 89, - P. 118.

93. Ibid 89, - PP.120-121.


96. Ibid 89, - P. 108.

98. Ibid 89, - P. 99.


103. Ibid 89, - P. 102.


105. Ibid 89, - P. 102.


"Most fantastic results can be obtained by attempting to average certain items or figures which are not truly comparable."


111. S.C. Kuchhal, - Financial Management (1977), - P. 496.


113. Ibid 112, - Pp. 77-78.

114. Ibid 112, - P. 78.

115. Ibid 112, - P. 78.
117. Ibid 111, - P. 498.
118. Ibid 112, - P. 77.
119. Ibid 111, - P. 498.
120. R.L. Sidey, - The Valuation of Shares (1950), - P. 16.
121. Ibid 112, - P. 76.
122. Ibid 112, - P. 77.
123. Ibid 106, - P. 51.
128. Ibid 120, - P. 14.
129. Findlay's Trustees Vs. Ex Inland Revenue Commissioners (1936) 22 A.T.C. 437. Lord Fleming said: -
"I do not doubt that, when one is seeking to ascertain the profits which will probably be earned by a business in the future, it is quite usual to do so by taking an average of the profits actually earned ....... This probably operates quite equitably when one is dealing with a well established business, which has normal ups and downs but has no violent fluctuations..."
130. Discounted cash flow: - The discounted cash flow method used in project evaluation "takes into account the differences in timing of cash flows, and isolate differences in the timing of cash flows for various projects by discounting these cash flows to..."
their present values." Rup Ram Gupta and Vidya Saran Gupta, - Advanced Accounting & Management Accounting (Eleventh edition, 1971) - P. 1025. The discounted cash flow method is of two types. These are:

(i) The present value method, under which all cash flows are discounted to present value by using the required rate of return.

(ii) Internal rate of return method, which stipulates the computation of an interest rate "that discounts all future cash inflows down to a present value equal to the present value of all cash outlays discounted at the same rate". Rup Ram Gupta and Vidya Saran Gupta, - Advanced Accounting & Management Accounting (11th edition, 1971), P.1027.

**Earnings rate:**

(i) For companies in which the shares are quoted in the stock exchange the earnings rate is calculated by dividing the earnings per share by the current market value of such shares and the result is multiplied by 100.

(ii) For companies in which the shares are not quoted in the stock exchange either the market quotations of similar companies may be used for ascertaining the earnings rate or the rate may be ascertained by dividing the net profit for equity shareholders by the equity shareholders' funds and the result is multiplied by 100.

**Tremaine Vs. Commissioner of Stamp Duties (1912) N.Z.L.R.157.**

134. Clifford, Re; Commissioner of Succession Duties (S.A.) Vs. Executor, Trustee & Agency Co. of S.A. Ltd. (1947) 74 C.L.R. 358.

135. & Ibid 133, - P.119.

136. Trustees of J.T. Salvesen Vs. Inland Revenue Commissioners (1930) 9 A.T.C. 43. Lord Fleming stated:

"The possibility of further Government control and restriction of the industry is a thing, however, which an investor might also regard as introducing an element of doubt and which might depreciate the amount he would be willing to offer for the shares."

137. Ibid 133, - P.94.

138. Holt Vs. Inland Revenue Commissioners (1953) 32 A.T.C. 402. The learned judge stated:

"........ I do not see how anyone considering the financial situation of the company could properly ignore the effects of inflation on the value of money .... "

139. Salvesen's Trustees Vs. Inland Revenue Commissioners (1930) 9 A.T.C. 43.


141. Divisible Profits:

The Companies Act, 1956 does not define the term "divisible profits". Sec. 205 of the Companies Act lays down that no dividend shall be declared or paid except out of profits of the company arrived at after providing for depreciation or out of moneys provided by the Central Government or a State Government for the payment of dividend in pursuance of a guarantee given by that Government.
But it is necessary to remember that all profits are not divisible. Divisible profits are only those profits which can be legally distributed to the shareholders of a company by way of dividend.

142. Preference shares: Under Section 85(1) of the Companies Act, 1956 preference shares, with reference to any company limited by shares, are those which have two dominant characteristics:
(a) as regards dividend, they must carry a preferential right to a fixed amount or an amount calculated at a fixed rate; and
(b) as regards capital, in the event of liquidation or other arrangement for repayment of capital, they must carry a preferential right for the repayment of the amount of capital paid up or deemed to have been paid up on such shares. In addition to the above two rights, a preference share u/s 85 may or may not carry such other rights as the following:

* 1. a preferential right as to the payment of any arrears of dividend on such a share;
* 2. a preferential right for the payment of a fixed premium specified in the memorandum or articles of the company;
* 3. a right to participate with equity shares in the surplus profits;
* 4. a right to participate with equity shares in the surplus assets in the case of liquidation of the company, after the entire capital has been repaid.

( Sec. 85(1)(b)(i) and Sec. 85(1)(b)(ii).

Explanation to Sec. 85(1).
Equity shareholders are the owners of the equity share capital of a company. "Equity share capital" means, with reference to any company limited by shares, "all share capital which is not preference share capital." (Sec. 85(2)).


Ibid 106, - P. 51.

Ibid 53, - P. 509.

Ibid 41, - P.24.


J.C. Bonbright, - valuation of property (1937), P.260.


(A) "Perfect competition" exists only in the case where no farmer, business, or laborer is a big enough part of the total market to have any personal influence on market price..." (P.39)

(B) A perfectly competitive market is one "where some kind of standardized good such as wheat is being auctioned by an organized exchange that registers transactions of numerous buyers and sellers." (P.61)

(C) Samuelson while outlining the various types of competition stated the following about perfect competition:

<table>
<thead>
<tr>
<th>Number of producers and</th>
<th>Degree of product differentiation.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Many producers</td>
<td>Identical Products.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Part of economy where prevalent.</th>
<th>Degree of control over price</th>
<th>Methods of marketing</th>
</tr>
</thead>
<tbody>
<tr>
<td>A few agricultural industries.</td>
<td>None</td>
<td>Market exchange or auction. (P.463)</td>
</tr>
</tbody>
</table>
To sum up, perfect competition is said to exist, when the following four conditions are found in a market:

1. Existence of a large number of buyers and sellers, so that a single firm in the industry containing numerous firms is just like a drop in the Ocean and can exercise no control over the price.

2. Homogeneous product.

3. Availability of perfect information about the prevailing market price to the buyers and sellers.

4. Free entry into and exit from the industry for any firm.

A market is said to be imperfect when there are "many differentiated sellers" i.e. sellers with "many real or fancied differences in product" having some degree of control over price.

In the practical world it is hard to get a perfectly competitive market. In the words of Samuelson, -

"Needless to say, the requirements for absolutely perfect competition are as hard to meet as the requirements for a perfectly frictionless pendulum in physics. We can approach closer and closer to perfection, but can never quite reach it."*


152. Ibid 151, - pp. 462 - 463.

153. Ibid 151, - pp. 78-79.


159. Murdoch (Sir James) Re ; Perpetual Trustee Co. Vs. Federal Commissioner of Taxation (1942) 65 C.L.R. 573.


163. (a) Shares of private companies as defined in Sec. 3(1)(iii) of the Companies Act,1956, are not quoted on a stock exchange.
(b) A public limited company may apply to a stock exchange for quotation of its shares. There is no guarantee that the application for "permission to deal" will be granted by the Stock Exchange authorities.
(c) Stock Exchange means a "recognised stock exchange" within the meaning of Sec. 2(39)of the Companies Act,1956.


166. Ibid 154, - P. 141.

168. (i) Ibid 154, P. 141.
(iii) Ibid 154, P. 65.
169. Ibid 149, - P. 125
170. Ibid 164, - P. 165.
(ii) Federal Commissioner of Taxation Vs. Sagar, (1946) - 71 C.L.R. 421. In this case a 10% deduction was allowed from the price determined by the capitalisation of the market yield.
In this case the yield required was 11½ to 13½.
The Court considered the yield required to be 14½.
172. Ibid 154, - P. 142.


179. Ibid 177, p. 30-2 (30-3).

180. The Companies Act, 1956 (1 of 1956) - Sec. 94.

Sub-division allowed u/s 94(1)(d)
Consolidation allowed u/s 94(1)(b).

181. Ibid 180, Sec. 80 (Provisions relating to the issue and redemption of preference shares).

182. Ibid 180, Sec. 94(1)(e) - Conversion allowed.

183. Ibid 177, p. 30-2 (30-3).