Valuation of shares

In case of shares which are quoted on the stock exchange, the value of the share can be obtained from the daily list of prices published by stock exchanges. Although in some cases the stock exchange prices donot reflect the true value of shares, in many cases the prices of shares are not related directly to the value of a company's assets or to the amount of its profits and consequently, these quotations cannot form a fair ~~and~~ basis for valuation of shares. So, share of such a company are to be sold or pledged, the value of such share will have to be ascertained.

<u>Need of valuation of shares</u> There are following needs for the valuation of shares.

① when shares are received as a gift, it may be necessary to find out the exact value of shares for paying gift duty.

② for the assessment of wealth tax.

③ when a person dies, then it is necessary to find out the value of shares for paying death duties.

(4) for purchase and sale of shares in private companies

(5) for formulating amalgamation and internal reconstruction schemes

(6) for compensating the shareholders when the company is nationalised.

(7) when shares of one class are to be converted into shares of another class.

(8) when shares are pledged as a security for a loan.

Methods of Valuation of shares

1. Net Asset Methods
2. Yield Methods
   - Dividend yield method
   - Earning Capacity method
3. Average Method

① **Net Asset**: This Method is known as Break up value Method, Intrinsic value Method, Assets valuation or Assets backing Method.

$$\text{Value of Shares} \Rightarrow \frac{\text{Net Assets}}{\text{Number of Equity shares}}$$

Ist Method **To calculate net Assets**

Net Assets: All Assets (~~Subtracting~~ Excluding Fictitious Assets) at Market value.

less Outside Liabilities (whether long term or short term)

less Preference share Capital or Preference dividend

IInd Method: **To calculate net Assets**

Net Assets: Equity share Capital + Reserve & surplus + Accumulated Profits + Profit on Revaluation of Assets − Accumulated losses − Preliminary Expenses.

Suitability:
① where a scheme of amalgamation is to be formulated
② when it is intended to liquidate the Company
③ where reliable information about Earning Capacity of the Company is not available. as in the case of newly established co.

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② **Yield Method** :- This method is divided into two parts :-

(a) **Dividend yield Method** :- Under this Method, the value of the shares is calculated by comparing the expected rate of dividend of this concern with the normal rate of dividend as prevailing in that Industry. acc to it :-

$$\text{Value of Share} = \frac{\text{Expected Rate of Dividend}}{\text{Normal Rate of Dividend}} \times \text{paid up Value of share.}$$

There are two elements to be ascertained in order to calculate the value of a share :-

① Ascertaining the Expected Rate of Dividend

② Ascertaining the Normal Rate of Dividend

One would expect a higher normal rate of return for Investing in business which are riskier.

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$$\frac{\text{Profit of the Company} \; \text{less} \left.\begin{array}{l}\text{Income Tax}\\ \text{Transfer to Reserve}\\ \text{Transfer to Debenture sinking fund}\\ \text{Preference Dividend}\end{array}\right]}{\text{paid up value of Equity share Capital}} \times 100$$

Suitability :- ① This method is appropriate for an investor who wishes to hold the shares for a short term.

② When there are no past losses and the firm is declaring regular dividend.

③ Where there are no plans to liquidate the Co. in near future.

② **Earning Capacity Method** :→ This Method is ap appropriate to find out the value of shares on the basis of Earnings of the Company. In this Method, the rate of earning of the Company is compared to the normal rate of return prevailing in the Industry. The formula is :-

$$\text{Value of Shares} = \frac{\text{Rate of Earnings}}{\text{Normal Rate of Return}} \times \text{Paid up value of Share.}$$

There are two elements to be ascertained in order to calculate the value of a share :

① Rate of Earnings

Normal Rate of Returns

One would expected a higher normal rate of return for Investing in Business

① Rate of Earning = $\frac{\text{Estimated future Earning}}{\text{Capital Employed}} \times 100$

Estimated future Earning → Profit of Company after Tax but before the following →
(a) Interest on Debenture
(b) Preference Dividend
(c) transfer to General Reserve

$$\frac{\text{Estimated future Earning}}{\text{Capital Employed}} \times 100$$

Here Capital Employed = All Assets (excepting all fictitious Assets) − Current liabilities

Suitability :- This Method is appropriate when the earning of Company is stable, ~~~~.

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