Lesson 20

Valuation of Shares, Business and Intangible Assets

Key Concepts One Should Know

- Valuation of shares
- Valuation of goodwill
- Valuation methods

Learning Objectives

To understand the:

- Need for valuation
- Different methods for valuation of shares
- Different methods for valuation of goodwill
- Internally generated goodwill
- Methods for valuation of business
- Role of different regulatory authorities in valuation

Lesson Outline

- Need for Valuation
- Methods of Valuation of Shares Net Asset Method
- Earning Basis
- Fair Value of Preference Shares
- Valuation of Business Asset Approach
- Earning Value Approach
- Market Value Approach
- Valuation of Intangible Asset
- Meaning of Goodwill
- Methods of Valuation of Goodwill
- Regulatory Valuation
- SEBI
- FEMA

  Income Tax Act

  Companies Act

  RBI
- LESSON ROUND-UP
- GLOSSARY
- TEST YOURSELF

NEED FOR VALUATION

The necessity for valuation arises for statutory as well as commercial reasons:

(i) Assessment under wealth tax act, gift tax act

(ii) Formulation of scheme for amalgamation

(iii) Purchase and sale of shares of private companies

(iv) Raising loan on the security of shares

(v) For paying court fees

(vi) Conversion of shares

(vii) Purchase of block of shares for the purpose of acquiring interest or otherwise in another company

(viii) Purchase of shares by the employees of the company where retention of such shares is limited to the period of their employment

(ix) Compensation to the shareholders by the government under a scheme of nationalization

(x) Acquisition of shares of dissentient shareholders under a scheme of reconstruction.

Normally a stock exchange is the most common source of ascertaining the value of shares especially for transactions involving small block of shares which are quoted on stock exchanges. But stock exchange prices form an unreliable basis because prices on a particular day are generally determined on the basis of demand and supply which are influenced by factors outside the business.

The wide fluctuations in prices of shares at the stock exchange are the outcome of actions and opinions of the private and institutional investors all over the country and indeed the world.

Thus the valuation of shares has to be done by the accountant by adopting sound and reasonable basis. Various tax laws make specific provisions regarding the valuation of shares and lay down either the general principles or the exact procedures to be followed.

Factors Affecting Valuation of Shares

The principle factors which have to be taken into consideration for valuing the shares of a joint stock company are :

1. Earnings or profitability and stability of profits
2. The yield or returns from other similar companies
3. The dividend policy of the company
4. Unfavourable financial ratios
5. Net assets position
6. Capital employed
7. The size of the block of the shares to be valued
8. Policy of the government

METHODS OF VALUATION OF SHARES

There are two principal methods of valuation of shares :

Methods of Valuation of Shares

- Net Assets Method
- Earning Basis Method

NET ASSET METHOD

Valuation of shares on net asset basis is also called asset backing or intrinsic value or break up value method. Under this method, the value per share is arrived at by valuing the assets of the company and deducting all liabilities and claims of the preferred shareholders and dividing the net assets by total equity shares with the same paid up value. Unless otherwise stated, goodwill is included in net assets.

In all cases of valuation on assets bases on, except those based on book value basis, it is important to arrive at current replacement and realization value. It is more so in case of assets like patents, trade marks, know-how, etc., which may possess values substantially more or less than those shown in the books.

The mechanism of asset valuation is simple:

(i) Arrive at the current replacement costs of assets for valuation based on appraisal or, in the case of a firm which is not a going concern, determine the net realizable value for break up valuation and deduct there from all liabilities in the books of account and such other liabilities which have not been recorded but are likely to rank for payment, and the amount payable to preferred shareholders. The approach should be conservative. Under provision for taxation, liabilities on account of gratuities, arrears of preference dividends, etc., are instances of what may not appear in books.

(ii) If circumstances suggest existence of goodwill from a study of the profit record, particular advantages, etc., the same should be evaluated with reference to any method appropriate for the purpose for addition to the result obtained in (i) above.

(iii) The result, as arrived at, shall represent the asset value for the whole undertaking; to arrive at value per share, the same should be divided by the number of equity shares in the company, provided all shares are equally paid up. If the company has equity shares of varying fully paid-up values, the total value should first be allocated to the different paid-up value groups and each such allocation would be divided by the number of shares in each of such groups.

The Net Asset Method may be written as follows :

Total Realizable value of assets	xx
Less: Total amount payable to outside liabilities	xx
BALANCE	xx
Less: Preference Share Capital (Paid-up value)	xx
Balance available for Equity Shareholders	xx

$$\text{Valuation per Equity Share} = \frac{\text{Balance available for Equity Shareholders}}{\text{No. of Equity Shares with same paid up value}}$$

Alternatively, the valuation of equity shares by the net asset method can also be arrived at as follows :

Equity Share Capital	xxx
Add: Reserves	xxx
Other surpluses	xxx
Profit on revaluation	xxx
Gross Equity	**xxx**
Less: Loss on revaluation	xxx
Miscellaneous expenditure	xxx
Accumulated losses	xxx
Net Equity	xxx

$$\textbf{Valuation per Equity Share} = \frac{\text{Net Equity}}{\text{No. of Equity Shares}}$$

Illustration 1.

The following particulars are available in relation to X Ltd.

(i) Capital : 4500, 8% Preference shares of Rs 100 each fully paid and 50,000 equity shares of Rs. 10 each fully paid

(ii) External liabilities : 50,000

(iii) Reserves and Surplus : Rs. 50,000

(iv) The average expected profit (after taxation) earned by the company: Rs. 1,05,000

(v) The normal profit earned on the market value of equity shares (fully paid) of the same type of companies is 10%

(vi) 10% of the profits after tax is transferred to reserves.

Calculate the intrinsic value per equity share and value per share according to dividend yield basis. Assume that out of total assets, Rs. 4,000 worth of assets are fictitious.

Solution:

(i) **Intrinsic value of shares**	**Rs.**
Preference share capital	4,50,000
Equity share capital	5,00,000
Reserves and surplus	50,000
External liabilities	85,000
	10,85,000
Less: Fictitious Assets	4,000
External liabilities	85,000
	9,96,000
Less: Preference share capital	4,50,000
Assets available for equity shareholders	5,46,000

Intrinsic value per share = $\frac{5,46,000}{50,000}$

= Rs. 10.92

(ii) Dividend Yield Basis

Average profit after tax	1,05,000
Less: transfer to reserve	10,500
Dividend on preference shares	36,000
Profits available for equity shareholders	58,500

Rate of dividend = $\frac{58,500}{5,00,000} \times 100$

= 11.7%

Value per Equity share = $\frac{11.7 \times 10}{10}$

= Rs. 11.70

EARNING BASIS METHOD

In most of the cases, the investor is interested in the earnings of the company since the business enterprise is accepted as a going concern. The earning basis of share valuation is expressed through:

(i) Yield method or Dividend yield method

(ii) Earning Capacity method

Valuation based on Rate of Dividend

This method of valuation is suitable for small blocks of shares because small shareholders are usually interested in dividends. The value of a share according to this method is ascertained as follows:

$$\text{Value of share} = \frac{\text{Possible rate of dividend x Paid up value per share}}{\text{Normal rate of dividend}}$$

OR

$$= \frac{\text{Dividend (in rupees) per share}}{\text{Normal rate of dividend}} \times 100$$

$$\text{Possible rate of dividend} = \frac{\text{Total profit available for dividend}}{\text{Total paid up equity capital}} \times 100$$

In other words, dividend on equity shares should be calculated by deducting from the maintainable profits:

(i) taxation;

(ii) transfers to reserve;

(iii) transfers to debenture redemption fund;

(iv) preference dividend, and by dividing the remaining by the number of shares.

Valuation based on Rate of Earning

This method of valuation of shares is suitable for valuing large block of company's shares because they are more interested in company's earnings rather than what the company distributes in the form of dividends. The value of a share on this basis can be calculated as follows:

$$\text{Value of share} = \frac{\text{Rate of Earning x Paid-up Value per Share}}{\text{Normal Rate Of Earning}}$$

$$\text{Rate of earning} = \frac{\text{Actual Profit Earned} \times 100}{\text{Capital Employed}}$$

Rate of earning is calculated by taking into account the total capital employed including long-term borrowings.

Since the total capital is taken into account, the profit figure should be before debenture interest, preference dividend, but after income tax. This is quite appropriate when the dividend is much more than the rate of earning on capital.

Valuation based on price earning ratio: This method is suitable for ascertaining the market value of shares which are quoted on a recognized stock exchange. According to this method, the shares are valued on the basis of earning per share multiplied by price earning ratio. Thus,

$$\text{Market Value of Share} = \text{Price Earning Ratio} \times \text{Earning Per Share}$$

$$\text{Earning Per Share} = \frac{\text{Profit available for equity shareholders}}{\text{Number of Equity Shares}}$$

$$\text{Price Earning Ratio} = \frac{\text{Market value per share}}{\text{Earning Per Share}}$$

CAPITALIZATION FACTOR: The value of a share according to yield basis can also be ascertained by finding out the capitalization factor or the multiplier. The capitalization factor will be ascertained by dividing 100 by the normal rate of return.

$$\text{Capitalization Factor} = \frac{100}{\text{Normal Rate of Return}}$$

The profit available is capitalized by multiplying it with the capitalization factor. The value of equity share is obtained by dividing the capitalized value by the number of equity shares.

FAIR VALUE OF SHARES

The fair value of shares can be calculated by using the following formula:

$$\text{Fair Value of Share} = \frac{\text{Value by Net Asset Method} + \text{Value by Yield Method}}{2}$$

This method is also known as dual method of share valuation. This method attempts to minimize the demerits of both the methods. This is, of course, no valuation but a compromised formula for bringing the parties to an agreement. However, it is recognized in the government circles for valuing shares of investment companies for wealth tax purposes.

VALUATION OF PREFERENCE SHARES

The yield-based valuation of preference shares would hold good only if:

(i) the dividend on the share has been paid regularly, and it is reasonably expected that it would continue to be paid; and

(ii) that investment is adjudged by the criteria that the total assets of the concern are equal to 4 or 5 times the preference capital.

Preference shares may have certain additional rights. For example, the right to get an additional share of profi or the right to get the share converted into equity shares at a certain rate. The right to get an additional share of profi will probably increase the market value of the share depending upon the size of the total profi and the conditions under which the additional dividend will come to preference share holders. Total yield per share will have to be worked out and on that basis the market value will be ascertained by the formula:

$$\frac{\text{Total Yield Per Share}}{\text{Normal Rate of Yield}} \times 100$$

Illustration 2.

Diamond Limited

Balance Sheet as at 31st March, 2014

Particulars	**Note No.**	**Amount as at 31st March,2014**
I. EQUITY AND LIABILITIES		
(1) Shareholders' funds		
(a) Share Capital		2,00,000
(b) Resrve and Surplus	1	72,000
(2) Current liabilities		
(a) Trade payable		1,28,000
(b) Provision for Income Tax		60,000
TOTAL		**4,60,000**
II. ASSETS		
(1) Non-current assets		
(a) Fixed Assets	2	2,60,000
(b) Preliminary expenses	2	12,000
(2) Current Assets		
(a) Inventories		48,000
(b) Trade receivable		88,000
(c) Cash at bank		52,000
TOTAL		**4,60,000**

Note No. 1.

Reserve and Surplus

General reserve	40,000
Profit and loss account	32,000
	72,000

Note No. 2.

Fixed Assets

Land and buildings	1,10,000
Plant and machinery	1,30,000
Patents	20,000
	2,60,000

The expert valuer valued the Land and Buildings at Rs. 2,40,000; Goodwill at Rs. 1,60,000; and Plant and Machinery at Rs. 1,20,000. Out of the total debtors, it is found that Debtors of Rs. 8,000 are bad. The profits of the company have been as follows:

	Rs.
31.3.2012	92,000
31.3.2013	88,000
31.3.2014	96,000

The company follows the practice of transferring 25% of profits to General Reserve. Similar type of companies earn at 10% of the value of their shares. Ascertain the value of shares of the company under:

(i) intrinsic value method;

(ii) yield value method; and

(iii) fair value method.

Solution:

Diamond Ltd.

Valuation of shares

(i) Intrinsic Value Method

Assets:	**Rs.**
Land and Buildings	2,40,000
Goodwill	1,60,000
Plant and Machinery	1,20,000
Patents and Trade Marks	20,000
Stock	48,000
Debtors less bad debts	80,000
Bank Balance	52,000
	7,20,000
Less: Liabilities:	
Sundry creditors	1,28,000
Net assets	5,92,000

Intrinsic value of shares (each share) $= \frac{\text{Net Assets}}{\text{No. of shares}}$

$\frac{5,92,000}{20,000} = 29.60$

(ii) Yield Value Method	**Rs.**
Total profit of last three years	2,76,000
Less: Bad debts	8,000
Average profit = $\frac{2,68,000}{3} = 89,333$	2,68,000

Add: Decrease in depreciation on Plant and Machinery say	
@ 15% on Rs 10,000	1,500
Less: Increase in depreciation on land and building say	
@ 10% on Rs 1,30,000 {10% of (240000 – 110000)}	13,000
Average profit	77,833
Less: Transfer to Reserve @ 25% of 77,833	19,458
Profit available for Dividend	58,375

$$\text{Rate of Dividend} = \frac{58\,375 \times 100}{2\,00\,000}$$

$$= 29.187\%$$

$$\text{Yield value of each share} = \frac{\text{Rate of Dividend}}{\text{Normal Rate of Return}} \times \text{Paid-up value of each share}$$

$$= \frac{29.187 \times 10}{10} = \text{Rs. } 29.19$$

(iii) Fair Value Method

$$\text{Fair value of each share} = \frac{\text{Intrinsic value + Yield Value}}{2}$$

$$\frac{29.60 + 29.19}{2}$$

= Rs 29.40

Illustration 3.

The Balance Sheet of RNR Limited as on 31.12.2017 is as follows :

Equity & Liabilities	(Rupees in Lakhs)
1,00,000 equity shares of Rs. 10 each fully paid	10
1,00,000 equity shares of Rs. 6 each, fully paid up	6
Reserves and Surplus	4
Liabilities	10
	30
II. Assets	
Goodwill	5
Fixed assets	15
Other tangible assets	5
Intangible assets (market value)	3
Miscellaneous expenditure to the extent not written off	2
	30

Fixed assets are worth Rs. 24 lakhs. Other Tangible assets are revalued at Rs. 3 lakhs. The company is expected to settle the disputed bonus claim of Rs. 1 lakh not provided for in the accounts. Goodwill appearing in the Balance Sheet is purchased goodwill. It is considered reasonable to increase the value of goodwill by an amount equal to average of the book value and a valuation made at 3 years' purchase of average super-profit for the last 4 years.

After tax, profits and dividend rates were as follows :

Year	PAT (Rs. in Lakhs)	Dividend %
2014	3.0	11%
2015	3.5	12%
2016	4.0	13%
2017	4.1	14%

Normal expectation in the industry to which the company belongs is 10%.

Akbar holds 20,000 equity shares of Rs. 10 each fully paid and 10,000 equity shares of Rs. 6 each, fully paid up. He wants to sell away his holdings.

(i) Determine the break-up value and market value of both kinds of shares.

(i) What should be the fair value of shares, if controlling interest is being sold ?

Answer:

$$\text{Break up value of Re. 1 of share capital} = \frac{\text{Rs. 28.98 lakhs}}{\text{Rs. 16.00 lakhs}}$$

$$= \text{Rs. } 1.81$$

Break up value of Rs. 10 paid up share= 1.81 × 10 = Rs. 18.10

Break up value of Rs. 6 paid up share = 1.81 × 6 = Rs. 10.86

Market value of shares :

$$\text{Average dividend} = \frac{11\% + 12\% + 13\% + 14\%}{4}$$

$$= 12.5\%$$

$$\text{Market value of Rs. 10 paid up share} = \frac{12.5\% \times 10}{10\%} = \text{Rs. } 12.50$$

$$\text{Market value of Rs. 6 paid up share} = \frac{12.5\% \times 6}{10\%} = \text{Rs. } 7.50$$

(i) Break up value of share will remain as before even if the controlling interest is being sold. But the market value of shares will be different as the controlling interest would enable the declaration of dividend upto the limit of disposable profit.

$$= \frac{\text{Average Profit* x 100}}{\text{Paid up value of shares}}$$

$$= \frac{\text{Rs. 3.4 lakhs}}{\text{Rs. 16 lakhs}} \text{ x } 100 = 21.25\%$$

Market value of shares :

For Rs. 10 paid up share = $\frac{21.25\% \times 10}{10\%}$ = Rs. 21.25

For Rs. 6 paid up share = $\frac{21.25\% \times 6}{10\%}$ = Rs. 12.75

Fair value of shares = $\frac{\text{Breakup value + Market value}}{2}$

Fair value of Rs. 10 paid up share = $\frac{18.10 + 21.25}{2}$ = Rs. 19.68

Fair value of Rs. 6 paid up share = $\frac{10.86 + 12.75}{2}$ = Rs. 11.81

* (Transfer to reserves has been ignored)

Working Notes:

(A) Calculation of Average Capital Employed	*(Rs. in lakhs)*
Fixed assets	24.00
Other tangible assets	3.00
Intangible assets	3.00
	30.00
Less : Liabilities	10.00
Bonus	1.00
	19.00
Less : ½ of profits [½ (4.1 – Bonus)]	1.55
Average capital employed	17.45

(B) Calculation of Super Profit

Average profit = ¼ (3 + 3.5 + 4 + 4.1 – Bonus)		
= ¼ × 13.6 =	3.400	
Less : Normal profit = 10 % of Rs. 17.45 lakhs	1.745	
Super profit =	1.655	
3 Years' purchase of average super-profit = 3 × 1.655 = Rs. 4.965 lakhs		
Increase in value of goodwill = ½ (book value + 3 years' super profit)		
= ½ (5 + 4.965) = Rs. 4.9825 lakhs		
Net assets as revalued including book value of goodwill		24.00
Add : Increase in goodwill (rounded-off)		4.98
Net assets available for shareholders		28.98

VALUATION OF BUSINESS

Business valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to affect a sale of a business. In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, divorce litigation, allocate business purchase price among business assets, establish a formula for estimating the value of partners' ownership interest for buy-sell agreements, and many other business and legal purposes.

Three Business Valuation Methods

1. Asset-Based Approach

Basically, these business valuation methods total up all the investments in the business. Asset-based business valuations can be done on a going concern or on a liquidation basis.

- A going concern asset-based approach lists the business's net balance sheet value of its assets and subtracts the value of its liabilities.
- A liquidation asset-based approach determines the net cash that would be received if all assets were sold and liabilities paid off.

2. Earning Value Approach

These business valuation methods are predicated on the idea that a business's true value lies in its ability to produce wealth in the future. The most common earning value approach is Capitalizing Past Earning.

With this approach, a valuator determines an expected level of cash flow for the company using a company's record of past earnings, normalizes them for unusual revenue or expenses, and multiplies the expected normalized cash flows by a capitalization factor.

The capitalization factor is a reflection of what rate of return a reasonable purchaser would expect on the investment, as well as a measure of the risk that the expected earnings will not be achieved.

3. Market Value Approach

Market Approach refers to the notion of arriving at the value of a company by comparing it to the market value of similar publicly listed companies. The comparison is based on certain financial ratios or multiples, such as the price to book value, price to earnings, EV/EBITDA, etc., of the equity in question to those of its peers. This type of approach, which is popular as a strategic tool in the financial industry, is mainly statistical, based on historical data, and current market sentiments. This is also known as relative valuation method.

A market approach is a method of determining the appraisal value of an asset based on the selling price of similar items. The market approach is a business-valuation method that can be used to calculate the value of property or as part of the valuation process for a closely held business. Additionally, the market approach can be used to determine the value of a business ownership interest, security or intangible assets. Regardless of what asset is being valued, the market approach studies recent sales of similar assets, making adjustments for differences in size, quantity or quality.

VALUATION OF INTANGIBLE ASSETS

Intangible Assets

Intangible asset is defined as a capital asset having no physical existence, its value being dependent on the rights that possession confers upon the owner. Intangible assets are expected to benefit the firm beyond the current operating cycle of the business.

Accounting Standard (AS) 26 Intangible Assets issued by the Institute of Chartered Accountants of India deals with meaning and valuation of intangible assets. According to this Accounting Standard, an intangible asset is

an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

If an item covered by AS-26 does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognized as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognized at the date of the amalgamation.

(i) Following are the features of intangible assets :

(ii) It is non-physical in nature.

(iii) It gives the specific rights to the holders over several future years.

(iv) It is possible for multiple uses at the same time.

(v) It creates future value.

(vi) It is identifiable as non-monetary asset.

(vii) It has limited ability to protect property rights.

(viii) Investment in intangible assets is basically risky

Approaches for Valuing Intangible Assets

There are three approaches used in valuing intangible assets;

(i) Cost Approach

In cost approach, expenditure incurred in developing the asset is aggregated. If the asset has been purchased recently, its purchase price may be taken to be the cost.

(ii) Market-Value Approach

In market-value approach, valuation is made by reference to transactions involving similar assets that have taken place recently in similar markets.

(iii) Economic-Value Approach

Economic value approach is based on the cash flows or earnings attributable to those assets and the capitalizaiton thereof, at an appropriate discount rate or multiple rate.

Recognition and Initial Measurement of an Intangible Asset

An intangible asset should be recognized if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

Acquisition of Intangible Assets as Part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations. Judgement is required to determine whether the cost (i.e., fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition.

Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares and operating profit) or discounting estimated future net cash flows from the asset.

Amortization of Intangible Assets

1. Amortization Period

The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortization should commence when the asset is available for use.

As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortization is recognized whether or not there has been an increase in, for example, the asset's fair value or recoverable amount.

2. Amortization Method

The amortization method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortization charge for each period should be recognized as an expense, unless some Accounting Standard permits or requires it to be included in the carrying amount of another asset.

Recoverability of the Carrying Amount – Impairment Losses

To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets, which explains how an enterprise reviews the carrying amount of its assets and how it determines the recoverable amount of an asset, and when it recognizes or reverses an impairment loss.

If an impairment loss occurs before the end of the first annual accounting period commences after the acquisition for of an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognized as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognized at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognized under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognized at the date of acquisition.

MEANING OF GOODWILL

Goodwill is an intangible but not a fictitious asset, which implies that it has some realizable value. From the accountants' point of view goodwill, in the sense of attracting custom, has little significance unless it has a saleable value. To the accountant, therefore, goodwill may be said to be that element arising from the reputation, connection, or other advantages possessed by a business which enables it to earn greater profits than the return normally expected on the capital represented by the net tangible assets employed in the business. In considering the return normally expected, the nature of the business has to be taken into consideration, the risks involved, fair management remuneration and any other relevant circumstances. The goodwill possessed by a firm may be due, inter alia, to the following:

1. The location of the business premises, the nature of the firm's products or the reputation of its services.
2. The possession of favourable contracts, complete or partial monopoly, etc.
3. The personal reputation of the promoters.
4. The possession of efficient and contented employees.
5. The possession of trade marks, patents or a well-known business name.
6. The continuance of advertising campaigns.
7. The maintenance of the quality of the firm's product and development of the business with changing conditions.

The need for evaluating goodwill may arise in the following cases:

1. when the business or when the company is about to be sold to another company or when the company is about to be amalgamated with another company;
2. when stock exchange quotations are not available, company's shares have to be valued for taxation purposes, gift tax, etc.;
3. when a large block of shares, so as to enable the holder to exercise control over the company concerned, has to be bought or sold; and
4. when the company has previously written off its goodwill and wants its right back. In the valuation of goodwill consideration of the following factors will have a bearing:
   (a) nature of the industry, its history and the risks to which it is subject to;
   (b) prospects of the industry in the future;
   (c) the company's history – its past performance and its record of past profits and dividends;
   (d) the basis of valuation of assets of the company and their value;
   (e) the ratio of liabilities to capital;
   (f) the nature of the management and the chances of its continuation;
   (g) capital structure or gearing;
   (h) size, location and reputation of the company's products;
   (i) the incidence of taxation;
   (j) the number of shareholders;
   (k) yield on shares of companies engaged in the same industry which are listed on the Stock Exchanges;
   (l) composition of purchasers of the products of the company;

Internally Generated Goodwill

Internally generated goodwill should not be recognized as an asset.

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

1. Research Phase

No intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

2. Development Phase

An intangible asset arising from development (or from the development phase of an internal project) should be recognized if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the intangible asset so that it is available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

(d) how the intangible asset will generate probable future economic benefits. Among other things, the enterprise should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

(e) its ability to measure the expenditure attributable to the intangible assets during its development reliably.

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as intangible assets.

METHODS OF VALUING GOODWILL

1. AVERAGE PROFITS METHOD

Under this method, goodwill is expressed to be a purchase of certain number of years profit based on the average of a given period. This involves two steps:

1. Calculation of average profit taking into consideration the profit of the preceding years.
2. Multiplying the average profit with number of purchase years.

Why Average Profits?

Goodwill is paid for obtaining a future advantage. However, the future is uncertain and is usually estimated on the basis of past. Therefore, in a business what profits are likely to accrue in the future depends upon its average performance in the past and hence the average profits.

Illustration 4.

X purchased business from Y on 30th June, 2017. Profit earned by Y for the preceding years ending on 31st December every year were- 2014 – Rs. 41,000, 2015 – Rs. 40,000 and 2016 – Rs. 42,000.

It was ascertained that profits of 2015 included a non- recurring item of Rs. 1500 and profit of 2016 was reduced by Rs. 2000 due to an extraordinary loss on account of theft. The annual premium was Rs. 200 per annum. X at the time of purchasing the business, was employed with Rama Bros and was getting Rs. 500 p.m. he intends to replace the manager who at the present is getting Rs. 350 p.m. the goodwill is calculated at 2 years purchase of the average profits. Calculate the goodwill of the business.

Solution:	**Rs.**
Profits (2014)	41,000
Profits (2015)	38,500 (40,000 – 1500)
Profits (2016)	44,000 (42,000 + 2,000)
Total Profits	**1,23,500**
Average profits = 1,23,500 / 3 =	41,167
Less: insurance premium(annual)	200
Salary (Rs 500 x 12)	6,000
Add: salary of manager (12 x 350)	4,200
Net average profit	39,167
Goodwill	= 39,167 x 2 = 78,334

2. SUPER PROFIT METHOD

In this case the future maintainable profits of the firm are compared with the normal profits for the firm. Normal earnings of a business can be judged only in the light of normal rate of earning and capital employed in the business.

There are three methods of calculating goodwill based on super profit which are as under:

(i) PURCHASE OF SUPER PROFIT METHOD

Goodwill as per this method is
= super profit x number of purchase years

(ii) SLIDING – SCALE VALUATION OF SUPER PROFIT

This method is a variation of the purchase method. This has been advocated by A.E. Cutforth, and is based upon the theory that the greater the amount of super profit, the more difficult it would be to maintain. In this method the super profit is divided into two or three divisions. Each of these is multiplied by a different number of years' purchase, in descending order from the first division. For example, if super profit is estimated at Rs. 2,25,000,

Goodwill is calculated as follows:

	Rs.
First Rs 75,000 say 5 years	3,75,000
Second Rs 75,000 say 4 years	3,00,000
Third Rs 75,000 say 3 years	2,25,000
Total goodwill	9,00,000

(iii) Capitalization of Super Profit

$$\frac{\text{Average Annual Super Profit}}{\text{Normal Rate of Return}} \times 100$$

Illustration 5.

From the following particulars of three companies ascertain the value of goodwill. Terms and conditions are as follows:

(i) Assets are to be revalued.

(ii) Goodwill is to be valued at four years' purchase of average super profits for three years. Such average is to be calculated after adjustment of depreciation at ten per cent on the amount of increase/decrease on revaluation of fixed assets. Income tax is to be ignored.

(iii) Normal profit on capital employed is to be taken at 10 percent, capital employed being considered on the basis of net revalued amounts of tangible assets.

The summarized Balance Sheets and relevant information are given below:

(Rs. in Lakhs)

Liabilities	**P Ltd.**	**Q Ltd.**	**R Ltd.**
Equity shares of Rs.10 each	24.00	28.00	12.00
Reserves	4.00	2.00	4.00
10 percent debentures	8.00	-	4.00
Expenses and creditors	8.00	6.00	4.00
	44.00	36.00	24.00

Assets

Goodwill	-	2.0	-
Net tangible block	32.00	24.00	20.00
Current assets	12.00	10.00	4.00
	44.00	36.00	24.00

	P Ltd.	Q Ltd.	R Ltd
Revaluation of tangible block	40,00,000	20,00,000	24,00,000
Revaluation of current assets	14,00,000	5,60,000	3,20,000
Average annual profit for three years before charging debenture interest	7,20,000	5,76,000	2,72,000

Solution:

	P Ltd.	Q Ltd.	R Ltd.
Average profit after charging debenture Interest	640,000	576,000	272,000
Less/Add : Depreciation on revaluation	(80,000)	40,000	(40,000)
	5,60,000	6,16,000	2,32,000
Less : Normal profit at 10% (WN1) (192,000)	(3,80,000)	(1,96,000)	
Super Profit	1,80,000	4,20,000	40,000
Goodwill at 4 years' purchase of super Profits	7,20,000	6,80,000	1,60,000

W.N.1 Calculation of Capital Employed

	P Ltd.	Q Ltd.	R Ltd.
Tangible fixed assets	40,00,000	20,00,000	24,00,000
Current assets	14,00,000	560,000	320,000
Less : Debentures and Creditors	(16,00,000)	(6,00,000)	(8,00,000)
	38,00,000	19,60,000	19,20,000

3. CAPITALIZATION OF AVERAGE PROFIT

The capitalization of profit method values goodwill at the excess of capital that should have been employed for earning the average profit over the capital which has been actually employed. In this method, the value of whole business is found by using the formula

$$\frac{\text{Average annual profit}}{\text{Normal rate of return}} \times 100$$

From this figure, net assets (excluding goodwill) of the firm are deducted and the resultant figure will be the goodwill.

Illustration 7.

International Ltd. is developing a new production process. During the financial year ending 31st March, 2017, the total expenditure incurred was Rs.50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2016. Expenditure incurred till this date was Rs. 22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2018 was Rs.80 lakhs. As at 31st March, 2018, the recoverable amount of know-how embodied in the process is estimated to be Rs. 72 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to calculate:

(i) Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2017 and carrying value of intangible as on that date.

(ii) Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2018. Ignore depreciation.

Solution:

(a) As per AS 26 'Intangible Assets'

(i) For the year ending 31.03.2017

(1) Carrying value of intangible as on 31.03.2017:

At the end of financial year 31st March 2017, the production process will be recognized (i.e., carrying amount) as an intangible asset at a cost of Rs. 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., on 1st December 2016).

(2) Expenditure to be charged to Profit and Loss Account:

The Rs. 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2017. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

(ii) For the year ending 31.03.2018

(1) Expenditure to be charged to Profit and Loss account:	***(Rs. in lakhs)***
Carrying Amount as on 31.03.2017	28
Expenditure during 2017–2018	80
Total book cost	108
Recoverable Amount	72
Impairment loss	36

Rs. 36 lakhs to be charged to Profit and Loss Account for the year ending 31.03.2008.

(2) Carrying value of intangible as on 31.03.2018:	**(Rs. in lakhs)**
Total Book Cost	108
Less : Impairment loss	36
Carrying amount as on 31.03.2018	72

Illustration 8.

Dell International Ltd. is developing a new production process. During the financial Year 31st March, 2016, the total expenditure incurred on this process was Rs. 40 lakhs. The production process met the criteria for recognition as an intangible asset on 1st December 2015. Expenditure incurred till this date was Rs.16 lakhs.

Further expenditure incurred on the process for the financial year ending 31st March 2017 was Rs.70 lakhs. On 31-03-2017, the recoverable amount of know-how embodied in the process is estimated to be Rs. 62 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to work out:

(a) What is the expenditure to be charged to the Profit and Loss Account for the financial year ended 31st March 2016? (Ignore depreciation for this purpose)

(b) What is the carrying amount of the intangible asset as at 31st March 2016?

(c) What is the expenditure to be charged to the Profit and Loss Account for the financial year ended 31st March 2017? (Ignore depreciation for this purpose)

(d) What is the carrying amount of the intangible asset as on 31st March 2017?

Solution:

(a) Rs. 16 lakhs

(b) Carrying amount as on 31-03-2016 will be expenditure incurred after 01-12-2015 = Rs. 24 lakhs

(c) Book cost of intangible asset as on 31-03-2017 is as follows Total Book cost = Rs.(70 + 24) lakhs = Rs. 94 lakhs Recoverable amount as estimated = Rs. 62 lakhs

Difference to be charged to Profit and Loss account = Rs. 32 lakhs

(D) Rs. 62 lakhs

Illustration 9.

A Pharma Company spent Rs. 33 lakhs during the accounting year ended 31st March, 2016 on a research project to develop a drug to treat "AIDS". Experts are of the view that it may take four years to establish whether the drug will be effective or not and even if found effective it may take two to three more years to produce the medicine, which can be marketed. The company wants to treat the expenditure as deferred revenue expenditure. Comment.

Solution:

As per para 41 of AS 26 'Intangible Assets', no intangible asset arising from research (or from the research phase of an internal project) should be recognized. Expenditure on research (or on the research phase of an internal project) should be recognized as an expense when it is incurred.

Thus the company cannot treat the expenditure as deferred revenue expenditure. The entire amount of Rs. 33 lakhs spent on research project should be charged as an expense in the year ended 31st March, 2016.

Illustration 10.

From the following data compute the 'Intrinsic' value of each category of equity shares of Ankit Ltd.:

Shareholders funds

100,000 'A' Equity shares of Rs.10 each, fully paid

100,000 'B' Equity shares of Rs.10 each, Rs. 8 paid

100,000 'C' Equity shares of Rs.10 each, Rs. 5 paid

Retained Earnings Rs.9,00,000

Solution:

Computation of Net assets

(i) Worth of net assets is equal to shareholders' fund, i.e.,

Paid up value of 'A' equity shares 100,000 x Rs. 10 = 10,00,000

Paid up value of 'B' equity shares 100,000 x Rs. 8 = 8,00,000

Paid up value of 'C' equity shares 100,000 x Rs. 5 = 5,00,000

Retained earnings = 9,00,000

Net assets = 32,00,000

Add: Notional calls (100,000 x 2 + 100,000 x Rs. 5) = 7,00,000

Intrinsic Value of each equity share of Rs. 100 fully paid up =39,00,000 / 300,000 = Rs. 13

(ii) Intrinsic values of each category of equity shares

'A' equity shares of Rs. 10 fully paid up Rs 13

'B' equity shares of Rs. 10 each, out of which Rs. 8 paid up(13-2)= Rs 11

Value of 'C' Equity shares of Rs. 10 each, out of which Rs. 5 paid up (13-5)= Rs 8

Illustration 11.

Average profit of a firm is Rs. 48,000. The rate of capitalization is 12%. Assets and liabilities of the firm are Rs. 4,00,000 and Rs. 1,70,000 respectively.

Solution:

Net Assets = Total assets – Outside liabilities

= 4,00,000 – 1,70,000

= Rs. 2,30,000

Value of goodwill = $\frac{\text{Average Profit}}{\text{NRR}} \times 100$ - Net Assets

= 48,000 x 100 / 12 – 2,30,000

= 4,00,000 - 2,30,000

= Rs. 1,70,000

Illustration 12.

A firm has a total capital investment of Rs. 2,25,000. The firm earned net profit during the last four years Rs. 35,000 , Rs. 40,000 , Rs. 60,000 , Rs. 50,000. The fair return on the net capital employed is 15%. Find out the value of goodwill if it is based on 3 years' purchase of the average super profits of past four years.

Solution:	**Rs.**
Total profit earned during four years	1,85,000
Average annual profit (1,85,000 /4)	46,250
Fair return on capital employed (15% of 2,25,000)	33,750
Super Profit (46,250 – 33,750)	12,500
Value of goodwill (12,500 x 3)	37,500

VALUATION GUIDELINES-REGULATORY REQUIREMENTS

There was no provision in the earlier company law i.e. the Companies Act, 1956 for valuation or specified persons who could conduct valuation of companies, shares etc. The concept of a "Registered Valuer" under Indian law was introduced for the first time vide Section 247 of Chapter XVII of the Companies Act, 2013 for matters requiring valuation under the said act.

The Ministry of Corporate Affairs has notified the provisions governing valuation by registered valuers [Section 247 of the Act, 2013] and the Companies (Registered Valuers and Valuation) Rules, 2017 ("Rules"), both to come into effect from 18th October, 2017.

As per section 247 of The Companies Act, 2013, Where a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets (herein referred to as the assets) or net worth of a company or its liabilities under the provision of this Act, it shall be valued by a person having such qualifications and experience, registered as a valuer and being a member of an organisation recognised, in such manner, on such terms and conditions as may be prescribed and appointed by the audit committee or in its absence by the Board of Directors of that company..

The valuer appointed shall,—

(a) make an impartial, true and fair valuation of any assets which may be required to be valued;

(b) exercise due diligence while performing the functions as valuer;

(c) make the valuation in accordance with such rules as may be prescribed; and

(d) not undertake valuation of any assets in which he has a direct or indirect interest or becomes so interested at any time 2during a period of three years prior to his appointment as valuer or three years after the valuation of assets was conducted by him.

The Rules provides the eligibility criteria which needs to be fulfilled for obtaining a certification for being a registered valuer and the manner in which the certification maybe obtained. The Rules also provide that the Insolvency and Bankruptcy Board of India ("IBBI") established under the Insolvency and Bankruptcy Code, 2016 be the "Registering Authority" which will hold examinations and grant certifications of the designation of a "Registered Valuer".

Valuation Guidelines Prescribed by the RBI under The Foreign Exchange Management Act, 1999

The Reserve Bank of India (the "RBI") is India's central banking institution, which controls the monetary policy of the Indian rupee (similar to the Federal Reserve System in the U.S.). Valuation guidelines are prescribed in the Master Circular on Foreign Investment in India (the "FEMA Circular") issued by the RBI, dated July 1, 2013.

The RBI, in its monetary policy announced on April 1, 2014, stated that it has decided to withdraw the valuation norms governing issue and transfer of shares under the foreign direct investment ("FDI") route and, going forward, transactions will be valued based on acceptable market practices. The announcement also indicated that the operating guidelines governing the same shall be notified separately.

All Indian companies issuing equity shares, fully and mandatorily convertible debentures, and fully and mandatorily convertible preference shares are subject to the pricing guidelines / valuation norms and reporting requirements, amongst other requirements, as prescribed under FEMA Regulations. To understand the valuation guidelines in an easier manner, the same have been bifurcated into inbound and outbound transactions as below:

Inbound Transactions (Money Coming Into India)

Transfer or issue of shares by an Indian resident to a non-resident:

In case of an unlisted entity: The RBI guideline states that the price for transfer or issue of shares by an Indian resident to a non-resident shall not be less than the Fair Value of shares as determined by:

- A Category I Merchant Banker registered with the Securities and Exchange Board of India (the "SEBI"), or
- A Chartered Accountant who is a member of the Institute of Chartered Accountants of India ("ICAI")

The sole valuation method prescribed by the FEMA Circular for the above stated purpose is the Discounted Free Cash Flow ("DCF") Method

In case of a listed entity: The RBI guideline states that the price for transfer or issue of shares by an Indian resident to a non-resident shall not be less than the market price of the shares as determined under the "SEBI guidelines for allotment of shares on preferential basis," which is as follows:

The issue of shares on preferential basis shall be made at a price not less than higher of the following:

- The average of the weekly high and low of the closing prices of the company's shares quoted on the stock exchange during the six months preceding the relevant date, or
- The average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

Outbound Transactions (Money Going Out of India)

Transfer of shares by a non-resident to an Indian resident:

In case transfer of funds exceed USD 5 million: The RBI guideline states that the price for transfer of shares by a non-resident to an Indian resident shall not be more than the Fair Value of shares as determined by:

- A Category I Merchant Banker registeredwith the SEBI
- In any other case: The RBI guideline states that the price for transfer of shares by a non-resident to an
- Indian resident shall not be more than the Fair Value of shares as determined by:
- A Category I Merchant Banker registered with the SEBI, or
- A Chartered Accountant who is member of the ICAI

In case of an outbound transaction, no specific valuation methodologies have been prescribed by the RBI; however, the following valuation methods have been recommended:

For valuing a minority stake

- Guideline Public Company Method

For valuing a controlling stake

- DCF Method
- Merger and Acquisition Method

VALUATION GUIDELINES UNDER SEBI

Valuation under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018

Pricing of frequently traded shares

Regulation 164 of Valuation of shares as per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018.

If the equity shares of the issuer have been listed on a recognised stock exchange for a period of twenty six weeks or more as on the relevant date, the price of the equity shares to be allotted pursuant to the preferential issue shall be not less than higher of the following:

a) the average of the weekly high and low of the volume weighted average price of the related equity shares quoted on the recognised stock exchange during the twenty six weeks preceding the relevant date; or

b) the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

If the equity shares of the issuer have been listed on a recognised stock exchange for a period of less than twenty six weeks as on the relevant date, the price of the equity shares to be allotted pursuant to the preferential issue shall be not less than the higher of the following:

a) the price at which equity shares were issued by the issuer in its initial public offer or the value per share arrived at in a scheme of compromise, arrangement and amalgamation under sections 391 to 394 of the Companies Act, 1956 or sections 230 to 234 the Companies Act, 2013, as applicable, pursuant to which the equity shares of the issuer were listed, as the case may be; or

b) the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on the recognised stock exchange during the period the equity shares have been listed preceding the relevant date; or

c) the average of the weekly high and low of the volume weighted average prices of the related equity shares quoted on a recognised stock exchange during the two weeks preceding the relevant date.

Pricing of infrequently traded shares

Regulation 165 of Valuation of shares as per Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018.

Where the shares of an issuer are not frequently traded, the price determined by the issuer shall take into account the valuation parameters including book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies: Provided that the issuer shall submit a certificate stating that the issuer is in compliance of this regulation, obtained from an independent valuer to the stock exchange where the equity shares of the issuer are listed.

Valuation under SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 2011

Pricing of frequently traded shares

Traded Turnover of Shares ≥ 10% [In the Last Twelve Calendar Months preceding the Month of Public announcement

Method of Valuation- Valuation to be done by a Merchant Banker or CA with 10 year experience

The offer price shall be the highest of,—

(a) the highest negotiated price per share of the target company for any acquisition under the agreement attracting the obligation to make a public announcement of an open offer;

(b) the volume-weighted average price paid or payable for acquisitions, whether by the acquirer or by any person acting in concert with him, during the fifty-two weeks immediately preceding the date of the public announcement;

(c) the highest price paid or payable for any acquisition, whether by the acquirer or by any person acting in concert with him ,during the twenty-six weeks immediately preceding the date of the public announcement;

(d) the volume-weighted average market price of such shares for a period of sixty trading days immediately preceding the date of the public announcement as traded on the stock exchange where the maximum

Volume of trading in the shares of the target company are recorded during such period, provided such shares are frequently traded;

Pricing of Infrequently traded shares

Traded Turnover of Shares < 10% [In the Last Twelve Calendar Months preceding the Month of Public Announcement

Method of Valuation- Valuation to be done by a Merchant Banker or CA with 10 year experience

Where the shares are not frequently traded, the price determined by the acquirer and the manager to the open offer taking into account valuation parameters including, book value, comparable trading multiples, and such other parameters as are customary for valuation of shares of such companies;

VALUATION UNDER INCOME TAX ACT, 1961

In case of Valuation of Shares, determining the fair market value (FMV) of shares is difficult particularly in case of unquoted equity shares.

Rule 11UA of the Income Tax Rules, 1962 prescribes a specific formula based on "Net Asset Value Approach". The Finance Act, 2017 has inserted Section 56(2) (x) so as to widen the scope of taxability of receipt of sum of money or property without/inadequate consideration.

New Valuation Guidelines (Rule 11UAA of Income Tax Rules, 1962)

Year of applicability: The valuation guideline is applicable from assessment year 2018-19 (i.e. financial year 2017-18).

The FMV of unquoted equity shares on the valuation date = (A+B+C+D - L)× (PV)/(PE)

Where

A= book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) in the balance-sheet as reduced by,- i) any amount of income-tax paid, if any, less the amount of income-tax refund claimed, if any; and ii) any amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;

B= the price which the jewellery and artistic work would fetch if sold in the open market on the basis of the valuation report obtained from a registered valuer;

C= FMV of shares and securities as determined in the manner provided in this rule;

D= the value adopted or assessed or assessable by any authority of the Government for the purpose of payment of stamp duty in respect of the immovable property;

L= book value of liabilities shown in the balance sheet, but not including the following amounts, namely:

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

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

iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;

iv) any amount representing provision for taxation, other than amount of income-tax paid, if any, less the amount of income-tax claimed as refund, if any, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;

v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;

vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares PE = total amount of paid up equity share capital as shown in the balance-sheet

PE= total amount of paid up equity share capital as shown in the balance-sheet

PV= the paid up value of such equity shares

Quoted shares and securities

- If received by way of transaction through recognized stock exchange the FMV would be the transaction value as recorded on such recognised stock exchange.
- If received by way of transaction carried out other than through any recognised stock exchange, the FMV would be: a) Average of the lowest and the highest price of the shares or securities quoted on recognised stock exchange on the valuation date; b) Where shares or securities are not traded on recognised stock exchange on the specified date, average of the lowest and the highest price of the shares or securities quoted on recognised stock exchange on a date immediately preceding the valuation date

Unquoted equity shares

FMV = (A +B+C+D – L) x (PV) / (PE) (i.e., same valuation approach as described above) Unquoted shares and securities (other than unquoted equity shares)

FMV would be the amount which would be fetched if sold in the open market on the specified date. This has to be supported by Valuation report by Merchant banker or a chartered accountant.

LESSON ROUND-UP

- There are two principal methods of valuation of shares: Net Assets Method and Earning Basis.
- Valuation of shares on net asset basis is also called asset backing or intrinsic value or break up value method.
- The earning basis of share valuation is expressed through: Yield method or Dividend yield method or Earning Capacity method.
- Yield basis valuation may take the form of valuation based on rate of return and productivity factor.
- The value of share as per Net Asset Method

$$\text{Valuation per Equity Share} = \frac{\text{Balance available for Equity Shareholders}}{\text{No. of Equity Shares with same paid up value}}$$

- The value of share as per rate of return method

$$\text{Value of share} = \frac{\text{Possible rate of dividend x Paid up value per share}}{\text{Normal rate of dividend}}$$

OR

$$= \frac{\text{Dividend (in rupees) per share}}{\text{Normal rate of dividend}} \times 100$$

- The value of shares as per rate of earnings method

$$\frac{\text{Value of share} = \text{Rate of earning}}{\text{Normal rate of earning}} \times \text{Paid-up value per share}$$

- The value of share as per Fair Value method

$$\text{Fair value of share} = \frac{\text{Value by net asset method}}{2} + \text{Value by yield method}$$

- Intangible asset is defined as a capital asset having no physical existence, its value being dependent on the rights that possession confers upon the owner. Accounting Standard (AS) 26 Intangible Assets issued by the Institute of Chartered Accountants of India deals with meaning and valuation of intangible assets.
- There are three approaches used in valuing intangible assets;cost approach , Market value approach, Economic value approach.
- The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life.
- The amortization charge for each period should be recognized as an expense unless some Accounting Standard permits or requires it to be included in the carrying amount of another asset.

GLOSSARY

Net Asset Method

The value per share is arrived at by valuing the assets of the company and deducting all liabilities and claims of the preferred shareholders and dividing the net assets by total equity shares with the same paid up value

Business valuation

Business valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business.

Intangible asset

Intangible asset is defined as a capital asset having no physical existence, its value being dependent on the rights that possession confers upon the owner.

Capitalization of average profit

The capitalization of profit method values goodwill at the excess of capital that should have been employed for earning the average profit over the capital which has been actually employed.

TEST YOURSELF

1. What do you mean by amortization of an intangible asset?
2. What are the different approaches for valuation of business?
3. How will you deal with internally generated goodwill in the books of accounts?
4. "Stock exchanges are the most common source for ascertaining the value of shares but still it forms an unreliable basis" explain the statement.
5. Write a short note on residual value of an intangible asset.
6. How is an intangible asset recognized? How is initial measurement of intangible asset is done?
7. Write short notes on capital market information-P/E ratio, yield ratio and market value/book value of shares.
8. Briefly discuss methods of valuation of intangible assets.