

GUIDELINES FOR VALUATION OF EQUITY SHARES OF COMPANIES AND THE BUSINESS AND NET ASSETS OF BRANCHES

PART I

1. These are operating guidelines for valuation of equity shares of companies. Briefly, they will be referred to as **valuation guidelines**.
2. These are purely administrative instructions for internal official use and are, therefore, not to be quoted, cited or published as the official guidelines of the Government.
3. They will be effective from the date* of their issue and will be applicable to all pending and future cases arising for consideration in the Department of Economic Affairs, Ministry of Finance.
4. Specially, these guidelines will be applicable to the valuation of:—
 - (a) equity shares of companies, private and public limited;
 - (b) Indian business/net assets of the sterling tea companies; and
 - (c) Indian business/net assets of the branches of foreign companies.

PART II

Principles and method of valuation

5. The objective of the valuation process is to make a best reasonable judgment of the value of the equity share of a company or of the business and net assets of a branch in cases arising for valuation under the Foreign Exchange Regulation Act, 1973, and the Capital Issues (Control) Act, 1947. The best reasonable judgment of the value will be referred to as the fair value (FV) and it will be arrived at on the basis of the following in the manner described in the subsequent paragraphs:

- (1) Net asset value (NAV);
- (2) Profit-earning capacity value (PECV);
- (3) Market value (MV) in the case of listed shares.

6.1 *Net asset value (NAV).*—The net asset value, as at the latest audited balance-sheet date, will be calculated starting from the total assets of the company or of the branch and deducting therefrom all debts, dues, borrowings and liabilities, including current and likely contingent liabilities and preference capital, if any. In other words, it should represent the true “net worth” of the business after providing for all outside present and potential liabilities. In the case of companies, the net asset value as calculated from the assets side of the balance-sheet in the above manner will be cross checked with equity share capital plus *free reserves and surplus*, less the likely contingent liabilities.

6.2. In calculating the net asset value, the following points shall particularly be kept in view:

- (i) If a new bonus issue or a fresh issue of equity capital is proposed, it shall be taken into account. The *face value* of the fresh issue of equity capital will be added to the existing “net worth” as at the latest balance-sheet date and the resulting “net worth” will be divided by the enlarged equity capital base, including the fresh issue as well as the new bonus issue.
- (ii) Intangible assets like goodwill, patents, trade marks, copyrights, etc., will not be taken into account in calculating the assets.
- (iii) Revaluation of fixed assets, if any, will ordinarily not be taken into account. But if the revaluation had taken place long ago, say nearly 15 years ago, it may not be reasonable to deduct it from the total assets.

* Issued by the Ministry of Finance, Department of Economic Affairs, vide File No. S. 11(21) CCI (11)/90, dated 13-7-1990.

- (iv) Any reserve which has not been created out of genuine profits or out of cash will not be taken into account, e.g., amalgamation reserve or reserve created by changing the method of depreciation or reserve created by revaluation of fixed assets, etc.
- (v) Provision for gratuity based on actuarial valuation, but not for taxes, as well as provision for any other terminal benefits due to the employees will be provided for and deducted as liabilities.
- (vi) Liabilities like arrears of preference dividend, unclaimed dividends, dividends not provided for separately but proposed to be paid out of reserves, miscellaneous expenditure to the extent not written off, debit balance on profit and loss account, arrears of depreciation, etc., will be provided for and deducted from the total assets. So also, adequate provision will be made for bad and doubtful debts.
- (vii) In the case of contingent liabilities, a judgment must be made of the liabilities that are likely to impair the net worth of the company and it should be provided for on the liabilities side. In order to do so, the clarifications necessary may be obtained from the company and their auditors.
- (viii) In the matter of provision for depreciation, the following approach will be adopted:
 - (a) If the company has *consistently* been following the straight line method of depreciation, the depreciation as provided for in the accounts may be accepted in calculating the net asset value and it is not necessary to reckon depreciation according to the written down value method as claimed by the company for income-tax purposes.
 - (b) If, however, within the preceding five years, the company has *switched over* from the written down value method to the straight line method, then the provision for depreciation will be reckoned according to the written down value method as if the company has not made the *switch over*. For this purpose, the company should be asked to furnish the necessary information, especially the depreciation claimed for income-tax purposes. Where, however, a company follows right from the beginning the straight line method for depreciation of *new* fixed assets, although it might be following the written down value method of valuation for the older assets, the depreciation as provided for in the accounts of the company will be accepted both for the old and new assets because this cannot be regarded as a *switch over* in the method of depreciation. The criterion for determining whether there has been a *switch over* or not is thus whether there has been a change in the method of depreciation in respect of the *same* fixed assets within the preceding five years.
 - (c) In the case of valuation of branches, the provision for depreciation will always be reckoned according to the written down value method. If the accounts are based on the straight line method, then the company must be asked to furnish the depreciation provision according to the written down value method.

6.3 The calculation of the net asset value will be recorded, with the necessary details, in the *pro forma* shown in *Annexure I*.

7.1 *Profit-earning capacity value (PECV)*.—The profit-earning capacity value will be calculated by capitalising the average of the after-tax profits at the following rates:

- (i) 15% in the case of manufacturing companies.
- (ii) 20% in the case of trading companies.
- (iii) 17½% in the case of "intermediate companies", that is to say, companies whose turnover from trading activity is more than 40%, but less than 60% of their total turnover.

7.2 While ordinarily, the capitalisation rate for a manufacturing company will be 15% there may be exceptional cases where the capitalisation rate may have to be liberalised in order to ensure fair and equitable valuation. Such cases, where discretion may need to be exercised, are illustrated below:

- (i) Where, in the case of a listed share, the average of the net asset value and the profit-earning capacity value based on 15% capitalisation rate is less than the average market price by a substantial margin, say by over 20%. In such cases, the company would usually have the following characteristics, viz., a track record of high and consistent dividend payments and bonus issues, established position as market leader in its field, a good reputation for the quality and integrity of its management, etc., and these would be reflected in the market price of the share.
- (ii) Where a company has a high profitability rate as revealed by the percentage of the after tax profits to the equity capital of the company.
- (iii) Where a company has diversified its activities and is a multi-unit company, as a result of which it would be in a position to sustain its overall profits even if any one part of its operations runs into difficulties.

In such cases, the capitalisation rate of 15% could be liberalised *suitably up to a maximum of 12%* with a view to arriving at a fair and equitable valuation. Needless to emphasise, this discretion should be exercised with great care and caution after taking into account all relevant factors.

7.3 The crux of estimating the profit-earning capacity value lies in the assessment of the *future maintainable* earnings of the business. While the *past* trends in profits and profitability would serve as a guide, it should not be overlooked that the valuation is for the *future* and that it is the *future* maintainable stream of earnings that is of greater significance in the process of valuation. All relevant factors that have a bearing on the future maintainable earnings of the business must, therefore, be given due consideration.

7.4 The provision for taxation, the method of computation of the average profits and the treatment of the profitability of the fresh issue of capital, if any, are of particular importance in the calculation of the future maintainable earnings. These are dealt with in the following paragraphs.

7.5 *Provision for taxation.*—For computation of profits after tax, provision for taxation will be assumed on the following basis:

- (a) *Widely held public limited companies* : Provision for taxation will be assumed at the current statutory rate under the Income-tax Act. If, however, "the actual tax liability" as shown in the audited accounts of the company is more than the current statutory rate, then the actuals will be assumed subject to a maximum statutory limit of income-tax plus surtax on companies under the Income-tax Act. The expression "actual tax liability" will mean the average of the tax liability (in percentage points) for the preceding three years or the actual tax liability in the latest accounting year, whichever is higher.
- (b) *Tea companies* : Provision for taxation will be assumed at 70% in consideration of the fact that on 40% of their profits, they have to pay Central income-tax, while on the remaining 60% of the profits, they have to pay the State agricultural income-tax, and that in addition, they may have to pay surtax also.
- (c) *Branches* : For branches converting themselves into public or private limited companies, provision for taxation will be assumed at 70% although as branches, they may be paying tax at the rate of 73.5%.
- (d) *Private limited companies and closely held public companies* : In the case of private limited companies, which propose to continue as private limited companies, provision for taxation will be the actual tax liability shown in the accounts of the company, subject to a minimum of the current statutory rate. If, however, the private limited company is being converted into a public limited company, the actuals will be restricted to a *maximum* of 70%. This position will hold good for closely held public limited companies also (*i.e.*, public limited companies not listed nor proposed to be listed on the stock exchange).

7.6 *Method of computation of average profits.*—Keeping in view that the objective is to arrive at a true and realistic estimate of the future maintainable earnings of the business, the following approach will be adopted in computing the average profits:

(1) It should broadly be checked that the profits shown in the audited accounts of the company are "true" profits and that there has been no attempt at "window dressing" of the accounts to inflate the profits. In particular, it is important to exclude non-recurring miscellaneous income of an abnormal nature or magnitude, writing back of provisions, etc.

(2) Ordinarily, the averaging of profits will be done for the latest *three* years for which audited accounts are available. But in appropriate cases, *e.g.*, where the capital base of the company and/or the fresh issue is of a sizable order or where the profits show erratic variation or where the premium involved is substantial or where the industry concerned is subject to cyclical trends, *e.g.*, "tea industry", it would be advisable to take into account the profits of the latest *five* years in order to arrive at a fair and realistic estimate of the future maintainable earnings.

(3) If the year to year variation in the profits of the last three years can be considered to be normal (a thumb rule for determining which could be that the annual variation does not exceed about 20% and the *maximum* does not vary by more than 50% from the *minimum*) the average may be calculated on the basis of a simple arithmetical average. But if the profits are rising consistently from year to year at a steady ratio and there are reasons to believe that the rising trend will be maintained, the average may be calculated on a weighted basis giving a weightage of 3 for the latest year, 2 for the middle year and 1 for the farthest year. In such cases, it will be pertinent to look into the accounts of the preceding two years also to check that the rising trend in profits is stable. Conversely, if the profits are declining *consistently* from year to year, it would be advisable to assume the profits of only the latest year because any average—simple or weighted—will give a higher figure than the profits of the latest year, and it will not be rational to assume a higher profit in a situation of consistently declining profits. Here also, it would be advisable to look into the accounts of the last five years to make a judgment on the trend in profits.

If a business has sustained losses in all the three years or even in the latest two years, the profit-earning capacity value will have to be regarded as "nil", because it would not then be realistic to assume that the business would earn profits in the near future. But if the business has sustained a loss in only one of the three years (the latest year could also be the odd year of loss) and there are reasons to believe that the loss in that year was a freak loss and does not represent the true earning potential of the business, it would be open to exclude the freak year and work out an average based on the working results of the remaining four of the latest five years. If, however, that average turns out to be more than the profits of the latest

year, then it would be advisable to assume, as a measure of abundant caution, the profits of the latest year.

It will be evident from the above that in the assessment of the future maintainable earnings, the exercise of discretion and judgment cannot altogether be avoided and that all facts and circumstances must be given due consideration before a view is taken.

7.7 Treatment of the profitability of fresh issue of capital.—In deciding upon the profitability of the additional capital being raised, the following factors must be looked into :

- (a) The purpose for which the capital is being raised; whether it is to finance a definite new or expansion project for which the company holds a letter of intent or an industrial licence.
- (b) Whether the expansion or the new project is "on the ground" and tangible progress has been made in implementing the project.
- (c) The forecast of future profits and profitability of the project.

7.8 Where the fresh issue of capital is for the purpose of financing and expansion or new project and there are reasons to believe that the project would maintain the profitability of the business, it could be assumed that the fresh capital would contribute to the profits up to a *maximum* of 50% of the existing rate of profitability; in other words the *maximum* will be calculated as under:

$$\frac{\text{Fresh capital}}{\text{Existing net worth}} \times \text{Existing profits after tax}$$

This will be added to the existing profits after tax and the total will be divided by the enlarged capital base to arrive at the future maintainable earnings per share.

But where the fresh capital is sought to be raised not for financing a concrete new or expansion project, but for general reasons like modernisation and replacement of assets, dilution of foreign equity or for getting the shares listed on the stock exchange, it would not be advisable to assume that the fresh capital will contribute to the profitability of the business in any tangible manner in the near future. In such cases, while the fresh issue of capital will be taken into account, no additional profits will be assumed.

7.9 The calculation of profit-earning capacity value will be recorded with the necessary details in the pro forma shown in *Annexure II*.

8.1 Market value.—The question of market value acting as a guideline factor for valuation will obviously arise only in those cases where the shares being valued are listed on the stock exchange. In such cases, the market value will be taken cognisance of in the following manner:

(1) The average market price will be determined taking into account the stock market quotations in the preceding three years (after making appropriate adjustments for bonus issues and dividend payment) as under :

- (a) the high and low of the preceding two years; and
- (b) the high and low of each month in the preceding 12 months.

(2) The average market price will be kept in the background as a relevant factor while settling the fair value (FV) unless there are reasons to believe that the market price is vitiated by speculative transactions or manipulative practices.

(3) The reasonableness of the fair value will be checked against the average market price on the following lines:

- (a) if the average of the net asset value and the profit-earning capacity value on 15% capitalisation rate is less than the average market price by about 20% only, then the average will be regarded the fair value.
- (b) if, however, the average of the net asset value and the profit-earning capacity value is less than the average market price by a substantial margin, say by over 20%, then the profit-earning capacity value may be reworked by liberalising suitably the capitalisation rate of 15% in the following manner:

If the average market price is more than 20% to 50% of the fair value, the capitalisation rate will be 12%. If the average market price is more than 50% to 75% of the fair value, the capitalisation rate will be 10%. If the average market price is more than 75% and above of the fair value, the capitalisation rate will be 8%.

The fair value will be determined on the basis of the average of the net asset value and the reworked profit-earning capacity value. Thus, while the market value will not be a direct "input" in valuation, it will be recognised and made use of in the aforesaid manner while determining the fair value of a listed share.

8.2 The details of the market price and the calculation of the average market price will be recorded in the pro forma shown in *Annexure III*.

9.1. **Fair value (FV).**—As indicated in para 5 above, the final valuation based on best reasonable judgment will be called the fair value (FV).

9.2. In the case of companies, the average of the net asset value and the profit earning capacity value based on the 15% capitalisation rate will be the starting point for determining the fair value. The following principles will be kept in view in arriving at the fair value :

(1) In the case of a listed share, if the average of the net asset value and the profit-earning capacity value on 15% capitalisation rate is less than the average market price by about 20% only, then the average will be regarded as the fair value.

(2) If, however, the average of the net asset value and the profit-earning capacity value is less than the average market price by a substantial margin, i.e., by over 20% then the profit-earning capacity value may be reworked by liberalising suitably the capitalisation rate of 15% up to a maximum of 8%. The fair value will be determined on the basis of the net asset value and the reworked profit-earning capacity value.

(3) As a matter of prudence, it may be desirable to deduct at least one year's dividend per share from the average of the net asset and profit-earning capacity values to arrive at the fair value. A cushion of this order may be required as a safeguard against future uncertainties.

(4) Where the profit-earning capacity value is "nil" or negligible, the fair value should be limited to half of the net asset value. If, however, the net assets comprise mostly liquid assets like cash and bank balances or easily realisable bank debts, the fair value may be fixed up to two-thirds of the net asset value or up to the actual cash and bank balances, if the latter is even higher. The rationale to the proposition is that if the business chooses to liquidate itself, it is likely to realise at least this value.

(5) If the share is neither listed nor proposed to be listed, the average of the net asset value and the profit-earning capacity value should be discounted by at least 1:15% to take account of the restricted mobility of the share.

9.3 In the case of sterling tea companies and branches, the fair value will be determined on the basis of the principles outlined in paras 10 and 11 below.

10.1 *Valuation of sterling tea companies.*—The "financial" valuation (as distinguished from the "physical" valuation done by the Tea Board) of the Indian business of sterling tea companies in the context of their Indianisation under the Foreign Exchange Regulation Act, will be done on the basis of the following principles:

- (a) The net asset value (NAV) will be calculated in the usual manner after deducting all contingent liabilities as well as the "UK assets and liabilities". In particular, the profits remittable to the parent company up to the date of valuation shall be deducted, as they are to be regarded as debts due to the parent company. Any revaluation of fixed assets will also be deducted from the total assets as explained in para 6.2(iii) above, unless the revaluation has taken place long ago. It should, however, be kept in view that the exclusion of revaluation does not lead to untenable results or to erratic valuations as between companies with similar assets.
- (b) Care should be taken to ensure that all income-tax liabilities are deducted from the assets before arriving at the net asset value (NAV). For this purpose, the Income-tax Department should be consulted to ascertain the income-tax dues receivable from the sterling companies.
- (c) The profit-earning capacity value (PECV) will be calculated by taking the average of the pre-tax profits of the five years from 1972-76 deducting 70% for tax provision and capitalising the after-tax profits to arrive at 15%.
- (d) If the net asset value (NAV) is less than the profit-earning capacity value (PECV), then the net asset value will be taken as the fair value of the Indian business. But if the net asset value is more than the profit-earning capacity value then the average of the two will be taken as the fair value. This is to ensure that the net asset value is backed by adequate profit potential and that the valuation does not in any event exceed the net asset value.

10.2 The final valuation will be determined on the basis of the Tea Board's report and the comments of the Ministry of Commerce thereon, after taking into consideration all relevant factors.

11. *Valuation of branches.*—The valuation of branches of foreign companies in the context of their Indianisation under the Foreign Exchange Regulation Act will be done on the basis of the following principles:

(1) Each case will be considered on its own merits because the method of Indianisation may differ from case to case, depending on its circumstances.

(2) If the Indian company proposes to take over only the business of the foreign branch together with specified assets and liabilities with the foreign branch it need not be objected to, unless there are reasons to justify a contrary view.

(3) As far as possible, the income-tax liability of the branch may be left to be discharged by the branch itself and the Indian company may not be saddled with this liability. This may require the branch being left with sufficient assets, e.g., the remittances to be made on account of past profits and head office liabilities, cash and bank balances out of the current assets, etc.

(4) Where the foreign branch is allowed to continue with a portion of the assets and liabilities, it is only for the purpose of its "winding up" after recovering the assets and discharging the liabilities. But it will not be permitted to carry on any manufacturing trading or commercial activity. If at the time of its winding up the assets exceed the liabilities, the surplus will be repatriated by it with the approval of the Reserve Bank.

(5) As regards valuation, it may be done on the basis of the book value of the fixed assets plus the current assets less the current and contingent liabilities *being actually taken over by the Indian company* subject to the condition that it is backed by profit-earning potential. For this purpose, the profit-earning capacity value (PECV) will be calculated on the basis of the average pre-tax profits of the last three years, tax provision at 70% and capitalisation at 15%. If the profit-earning capacity value is less than the net asset value mentioned above, then the valuation will be done on the basis of the average of the two values. In other words, the valuation should not in any event exceed the net asset value of the assets being taken over by the Indian company, and should not involve any payment directly or indirectly for intangible assets like goodwill, etc.

(6) As a general proposition, it would be better to exclude the unremitted profits and head office liabilities due to the parent company as if they are debts due to it, rather than to include them in the consideration payable by the Indian company.

Each case will, however, have to be considered on its own merits because there could be cases where a suitable capital base for the Indian company and foreign share in that capital base up to the level permitted by the Foreign Exchange Regulation Act would be dependent on the unremitted profits and head office liabilities forming a part of the total consideration.

12. *Valuation on the basis of "willing buyer—willing seller" concept.*—While, as a general rule, the concept of "willing buyer—willing seller" is not acceptable for various reasons, the price agreed to between the parties can be accepted in the following two categories of cases :

I. *Small value asset* : If the total consideration involved does not exceed Rs. 5 lakhs and the shares being transferred do not constitute more than 10% of the total equity shareholding of the company, the transaction may be approved if the price agreed to between the parties does not exceed—

- (i) the ruling market price, if it is a listed share;
- (ii) the price as certified by the auditors of the company if it is not a listed share.

To guard against the possibility of splitting the shares into small value transactions, only one such transaction in the same shares should ordinarily be allowed in a period of one year.

II. *Cases where the fair value is close to the price agreed to between the parties.*—If the fair value as determined according to these guidelines is less than the price agreed to between the parties by a very small margin only, say by about 10% only, it would be preferable not to disturb the price that the parties to the transaction have negotiated and settled amongst themselves.

Name of the company.....

According to the audited balance-sheet as on.....

Net asset value (NAV)

Rs. Lakhs.....	Rs. Lakhs.....
Total assets.....	Shareholders funds.....
<i>Deduct all liabilities:</i>	(1) Equity capital.....
1. Preference capital.....	(2) Free reserves.....
2. Secured and unsecured borrowings.....	Total.....
3. Current liabilities.....	<i>Deduct contingent liabilities:</i>
4. Contingent liabilities.....	1.
	2.
	3.
	4.
	5.
<i>Net worth:</i> _____	<i>Net worth:</i> _____
<i>Net worth:</i> _____	
<i>Add : (1) Fresh capital issue (face value)</i>	
	Total.....
Number of shares, including fresh and bonus issues	
Net asset value (NAV) per share	
Net asset value (NAV) according to the company's auditors	

Profit-earning capacity value (PECV)

Year	Profits before tax	Profits after tax	Dividend declared
1.			
2.			
3.			
4.			
5.			

Average profits before tax (on the basis of simple or weighted average as the case may be :

Deduct : Provision for taxation at.....%

Average profits after tax

Deduct : Preference dividend

Net profit after tax

Add : Contribution to profits by fresh issue, if any

Total profits after tax

Number of equity shares, including fresh and bonus issues

Earnings per share (EPS)

Profit-earning capacity value (PECV) at 15% capitalisation rate (i.e., by multiplying EPS by....)

PECV according to the company's auditors

ANNEXURE III

Average market price

	High	Low	Remarks
1. Year			
2. Year			
3. Latest year			
4. Month-wise			
1.			
2.			
3.			
(for preceding 12 months)			
Average market price on the above basis.....			

13. *General.*—It is important to stress the fact that, however elaborate and detailed the guidelines may be, the process of valuation cannot possibly be reduced to a uniform and inflexible arithmetical exercise. In the ultimate analysis, valuation will have to be tempered by the exercise of judicious discretion and judgment taking into account all relevant factors. There will always be several factors, e.g., quality and integrity of the management, present and prospective competition yield on comparable securities and market sentiment, etc., which are not evident from the face of the balance-sheets but which will strongly influence the worth of a share. Similarly the accounts might be “window dressed” with a view to presenting a brighter picture of the company’s working results. The guidelines are intended to provide the basic framework for valuation and to minimise the element of subjective consideration. While they should be applied fairly and consistently in all cases, they should not be regarded as eliminating the exercise of discretion and judgment needed to arrive at a fair and equitable valuation.

14. It would be useful to compare the basis of the valuation according to these guidelines with that of the company’s auditors. On the one hand, this will help reduce errors in calculation as well as a better understanding of the facts of the case, and on the other, this will enable us to explain the basis of our valuation to the company concerned.