CONCEPTUAL CLARITY NOTES
ON VALUATION FOR CA FINAL-
FINANCIAL REPORTING.

VALUATION:-

A) VALUATION OF GOODWILL
B) VALUATION OF SHARES &

A) VALUATION OF GOODWILL

VALUE OF GOODWILL

GOODWILL MEANS ADVANTAGE (NOT A REPUTATION NOTE THIS THING MY FRIENDS) WHICH ARISES DUE TO :-

PAST EFFORTS
PURCHASED EFFORTS &
LOCATIONAL EFFORTS.

*WE WILL VALUE THE GOODWILL DUE TO PAST & PURCHASED EFFORTS.

METHODS OF VALUATION OF GOODWILL:-

1. AVERAGE PROFITS METHOD: - FUTURE MAINTAINABLE PROFITS* NO. OF YEARS OF PURCHASE.
2. SUPER PROFITS METHOD: - SUPER PROFITS* NO. OF YEARS OF PURCHASE
3. CAPITALISATION METHOD: THIS METHOD DOES NOT REQUIRE NO. OF YEARS OF PURCHASE

GOODWILL ACCORDING TO CAPITALISATION METHOD: - SUPER PROFITS/NRR.

4. CAPITALISATION OF SUPER PROFITS METHOD: - SUPER PROFITS/NRR.

* FOR CAPITALISATION METHOD USE CLOSING CAPITAL EMPLOYED AND FOR CAPITALISATION OF SUPER PROFITS METHOD USE AVERAGE CAPITAL EMLOYED.

5. ANNUITY METHOD:- SUPER PROFITS OR FMP(AS THE CASE MAY BE IN THE QUESTION)* PRESENT VALUE OF ANNUITY FACTOR.

THINGS TO BE COMPUTED

A). FUTURE MAINTAINABLE PROFITS (FMP)
B). NORMAL RATE OF RETURN (NRR)
C). CAPITAL EMPLOYED
D). AVERAGE CAPITAL EMPLOYED
E). NUMBER OF YEARS OF PURCHASE

FUTURE MAINTAINABLE PROFITS (FMP)

FMP REPRESENT PROFITS OF FUTURE PERIODS BASED ON CERTAIN ASSUMPTIONS:-

1) IST PREFERENCE (PROJECTION METHOD).
2) IIND PREFERENCE (PAST PROFITS METHOD).

1. PROJECTION METHOD:- SALES, COGS AND EXPENSES ARE PROJECTED BASED UPON EXPECTATIONS.
2. PAST PROFITS METHOD (MOSTLY PREFERED METHOD).

YEARS

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
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<tbody>
<tr>
<td>PROFITS AFTER TAX (PAT)</td>
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</table>
+TAX EXPENSE

PBT (PROFITS BEFORE TAX)

+ - ABNORMAL ITEMS (REASON FOR ADDING/DEDUCTING – WONT OCCUR IN FUTURE)

+ - NON RECURRING ITEMS (PROFIT ON SALE OF MACHINERY)

+-RECTIFICATION OF ERRORS (REASON: THIS IS DONE BECAUSE WE NEED CORRECTED PROFITS)

+ - EFFECTS OF CHANGES IN ACCOUNTING POLICIES (THIS IS DONE BECAUSE PROFITS SHOULD BE AS PER NEW POLICIES)

+ - REVALUATION OF CURRENT ASSETS/CURRENT LIABILITIES (THIS IS DONE BECAUSE GOODWILL SHOULD BE BASED ON CORRECT VALUE.)

+ GOODWILL AMORTIZATION

- NON OPERATING/ NON TRADING INCOME (THIS IS DONE BECAUSE WE NEED BUSINESS PROFITS ONLY).

ADJUSTED PROFITS: - YEAR 1 YEAR 2 YEAR 3

NOW COMPUTE AVERAGE ADJUSTED PROFITS: - ADJUSTED PROFIT OF YEAR1+YEAR2+YEAR3

NO. OF YEARS

+ - FUTURE INCOME/ EXPENSE

FMPBT (FUTURE MAINTAINABLE PROFITS BEFORE TAXES)

FUTURE TAX

FMP
SOME IMP NOTES RELATED TO COMPUTATION OF FMP, PLEASE REMEMBER THESE IN YOUR MIND:-

**NOTE 1**: **FUTURE TAX**: THIS WILL EITHER BE GIVEN OR AVERAGE OF PREVIOUS YEARS PROFITS IS TAKEN.

**NOTE 2**: **ABNORMAL ITEMS**: WHENEVER ABNORMAL ITEMS CAN'T BE VALUED

**NOTE 3**: **ASSUMPTION REGARDING NON TRADE INVESTMENTS**: ALL INVESTMENTS WILL BE ASSUMED AS NON TRADE, IF QUESTION IS SILENT.

**NOTE 4**: **AVERAGE CAN BE**: SIMPLE, WEIGHTED & TREND LINE AVERAGE.

FLOWCHART (ON WHEN TO USE AVERAGE OR WEIGHTED AVERAGE METHOD FOR COMPUTING AVERAGE OF FMP.)

- CHECK NET PROFIT RATIO
  - AVAILABLE*
  - NOT AVAILABLE
    - INC OR DEC
      - INC OR DEC TRENDS DOES NOT EXIST ON ADJUSTED PROFITS
• TREND LINE AVG METHOD IS TO BE APPLIED IF QUESTION SPECIFIES IT IS

- $Y = a + bx$
- $Y =$ income
- $a =$ simple average
- $b =$ growth
- $x =$ variable from median
HOW TO COMPUTE CAPITAL EMPLOYED

<table>
<thead>
<tr>
<th>Sundry Assets</th>
<th>XXXXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Sundry Liabilities</td>
<td>XXXXX</td>
</tr>
<tr>
<td>Capital Employed</td>
<td>XXXXX</td>
</tr>
</tbody>
</table>

SOME IMPORTANT NOTES TO BE KEPT IN MIND WHILE COMPUTING CAPITAL EMPLOYED

1. All assets and liabilities should be after revaluation, after rectification and after change in accounting policies.
2. Sundry assets should not include goodwill.
3. Preliminary expenses should also not be included in Sundry assets.
4. Non-trade assets should not be included in Sundry assets.
5. Sundry liabilities does not include proposed dividend (it is treated as part of Reserve & Surplus).
6. Tangible capital employed means closing capital employed.
7. Average capital employed: opening capital employed + closing capital employed / 2
8. If opening capital employed is not given then

   Average capital employed: closing capital employed - 1/2 of rectified Pat.

   **Whenever we use weighted avg in FMP-----------then use closing CE
   ****WHEN WE USE SIMPLE AVG IN FMP...........................THEN USE AVG CAPITAL EMPLOYED.

HOW TO COMPUTE NORMAL RATE OF RETURN (NRR).

\[ \text{NRR} = \frac{\text{Average Dividend Earnings}}{\text{Average Market Price}} \]

*NRR should be after tax.*
HOW TO COMPUTE NO OF YEARS OF PURCHASE?(NYP)

IF NYP IS MISSING:- USE CAPITALISATION METHOD AND CAPITALISATION OF SUPER PROFITS METHOD.

IF NYP IS MISSING AND QUESTION REQUIRES NYP THEN ESTIMATE NYP FROM 3-5 YEARS BY GIVING NOTES.

IMPORTANT NOTE: - HOW TO IDENTIFY THE ERRORS IN QUESTION?

1) ERRORS WILL BE SPECIFICALLY STATED AS “WRONGLY” ENTERED, “WRONGLY” OMITTED OR “RECTIFICATION REQUIRED”.

2) ERRORS WILL BE ADJUSTED IN BOOKS OR THESE ADJUSTMENTS ARE REQUIRED IN BOOKS WILL BE MENTIONED IN QUESTIONS.

VALUATION OF SHARES

***************THE NEXT TYPE OF VALUATION THAT IS DONE BY VALUER IS VALUATION OF SHARES..........THE QUESTION HERE IS WHY SHOULD WE VALUE SHARES? WHAT IS THE NEED FOR THIS TYPE OF VALUATION?

THE ANSWER TO THIS QUESTION IS:-

IF RELIANCE LIMITED WANT TO ACQUIRE THE SHARES OF TATA LIMITED THEN FOR THIS ACQUIRING PURPOSE RELIANCE LIMITED WILL APPOINT THE VALUERS.........................VALUERS CAN BE ANY PROFESSIONAL IE....CA ETC. CA WILL VALUE THE SHARES OF TATA LTD & TELL TO RELIANCE LIMITED..................................IF RELIANCE LIMITED WILL FIND SUITABLE THE VALUE OF SHARES ..............................................IT CAN ACQUIRE THE SHARES OF TATA LTD.................................................................
1) INTRINSIC VALUE METHOD

- This method assumes hypothetical liquidation & calculates refund per equity shares.
FORMULAE:

SUNDARY ASSETS: XXXXX
LESS: SUNDARY LIABILITIES XXXXX
BALANCE XXXXXX

LESS:
PREFERENCE EQUITY SHARE CAPITAL XXXXXX
PROPOSED DIVIDEND XXXXXX
NET ASSETS AVAILABLE FOR EQUITY SHAREHOLDERS XXXXXX
+ NOTIONAL CALLS XXXXXX
TOTAL ASSETS AVAILABLE FOR EQUITY SHAREHOLDERS XXXXXX

SO,

INTRINSIC VALUE PER SHARE: TOTAL ASSETS AVAILAIBLE TO EQUITY SHAREHOLDERS EQUITY SHARE CAPITAL (AFTER CALLS).

***** INTRINSIC VALUE IS VALUE FOR EQUITY SHAREHOLDERS THAT IS WHY WE HAVE DEDUCTED THE CAPITAL & DIVIDEND OF OTHER MEMBERS VIZ................PREFERENCE SHAREHOLDERS.

***** OTHER NAMES OF INTRINSIC VALUE

- NET ASSETS BREAKUP VALUE PER SHARE
- NET WORTH PER SHARE
- BOOK VALUE PER SHARE

***** WE ALWAYS CALCULATE I.VALUE EX-DIVIDEND AND THEN ADD DIVIDEND PER SHARE TO ARRIVE AT CUM-DIVIDEND I.VALUE.EA

2). CAPITALISATION METHOD

EARNING CAPITALISATION METHOD( USED FOR LARGE LOT OF SHARES, PREFFERED METHOD IN COMPARISON TO DIVIDEND CAPITALISATION METHOD.)

FORMULAE:

VALUE OF SHARE: EARNING RATE* PAID UP CAPITAL
NRR (NORMAL RATE OF RETURN)
**EARNING ATTRIBUTABLE TO EQUITY SHAREHOLDERS**

1. **EARNING ATTRIBUTABLE TO EQUITY SHAREHOLDERS**:

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FMP XXXXXX
LESS: - PREFERENCE DIVIDEND XXXXXX
EARNING ATTRIBUTABLE TO EQUITY SHAREHOLDER XXXXXX
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2. **DIVIDEND CAPITALISATION MODEL**: - USED FOR SMALL LOT OF SHARES (NON PREFERRED METHOD.)

<table>
<thead>
<tr>
<th>VALUE OF SHARES:</th>
<th>DIVIDEND RATE</th>
<th>PAID UP CAPITAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NRR</td>
<td></td>
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</tbody>
</table>

- THIS METHOD IS APPLIED FOR VALUATION OF BOTH EQUITY & PREFERENCE SHARES,
- WHERE DIVIDEND RATE WOULD BE GIVEN IN QUESTION OR CALCULATED BY USING AVERAGE OF PAST-DIVIDENDS.

3. **FAIR VALUE METHOD**

(USED WHENEVER CONTROLLING INTEREST (MORE THAN 50% IS BEING TRANSFERRED))

FORMULAE:-

```
VALUE OF SHARES:-  INTRINSIC VALUE+ EARNING CAPITALISATION VALUE*1/2
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**IMPORTANT THING TO BE UNDERSTOOD IS HOW TO COMPUTE NRR?(FOR SHARES........................PREVIOUS ONE WAS FOR GOODWILL VALUATION SO PLEASE NOTE THAT DO NOT CREATE CONFUSION MY FRIENDS.)**

1. **BEST METHOD IS CAPM (CAPITAL ASSET PRICING MODEL.)**

2. **ALTERNATE METHOD FOR ESTIMATE NRR**

<table>
<thead>
<tr>
<th>NRR FOR INDUSTRY</th>
<th>XXXXX</th>
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<tbody>
<tr>
<td>+ - RISK FACTORS/NON RISK FACTORS</td>
<td>XXXXX</td>
</tr>
<tr>
<td>NRR OF THE COMPANY</td>
<td>XXXXX</td>
</tr>
</tbody>
</table>
RISK FACTORS GENERALLY CONSIDERED BY SHAREHOLDERS

RISK FACTOR 1: - DIVIDEND TRACK RECORD OF THE COMPANY Vs TRACK RECORD OF INDUSTRY.

RISK FACTOR 2: - DEBT-EQUITY RATIO OR CAPITAL GEARING RATIO.

DEBT-EQUITY RATIO: - LONG TERM DEBT

\[ \text{EQUITY SHAREHOLDER FUNDS} + \text{PREFERENCE SHAREHOLDERS} \]

CAPITAL GEARING RATIO: - LONG TERM DEBT + PREFERENCE SHARE CAPITAL

\[ \text{EQUITY SHAREHOLDER FUNDS} \]

DECESSION: - LOW RATIOS LOW RISK.

RISK FACTOR 3: - ASSET PRICING RATIO

FORMULAE: - INTRINSIC VALUE PER SHARE

\[ \text{PAID UP VALUE PER SHARE} \]

DECESSION: - HIGH RATIO HIGH RISK

RISK FACTOR 4: - COVERAGE RATIO

A). PREFERENCE DIVIDEND COVERAGE RATIO: - PAT

\[ \text{PREFERENCE-DIVIDEND} \]

DECESSION: HIGH RATIO LOW RISK.

B). EQUITY DIVIDEND COVERAGE RATIO: - PAT-PREF DIVIDEND

\[ \text{EQUITY DIVIDEND} \]

DECESSION: - HIGH RATIO LOW RISK.

****NON RISK FACTORS CAN BE IGNORED FOR ADJUSTMENTS IN NRR.

****RISK PREMIUM SHALL BE ASSUMED AS ½%

***PROFIT= NET PROFIT= PROFIT BEFORE AFTER TAX.