ANNEXURE NO. 1

C.C.I. GUIDELINES FOR VALUATION OF EQUITY SHARES

Guidelines for valuation of equity shares of Companies and Net Assets of Branches Issued by the Department of Economic Affairs Investment Division vide F No S II(21)CCI(11)90 dated 13 7 90

PART-I

The following are the guidelines for valuation of equity shares of companies and the business and net assets of branches

1 These are operating guidelines for valuation of equity shares of companies Briefly, they will referred to as 'valuation guidelines'

2 These are purely administrative instructions for internal officials use and are, therefore, not to be quoted, cited of 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 Economics Affairs, Ministry of Finance

4 Specially, these guidelines will be applicable to the valuation of the following

- Equity shares of companies, private and public limited
- Indian business/net assets of the Sterling tea companies
- 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 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 Capital Issues (Control)Act, 1947

5.1 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

- Net Asset Value ('NAV')
- Profit earning capacity value('PECV')
- Market Value('MV') in the case of listed share

NET ASSET VALUE

6 The NAV as 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 NAV 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 1 In calculating the NAV, the following points shall particularly be kept in view

1 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 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 new bonus issue

2 Intangible assets like goodwill, patents, trademarks, copyright etc will not be taken into account in calculating the assets

3 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.

4 Any reserve which has not been created out of genuine profit 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.

5 Provision of gratuity based on actuarial valuation, but net of taxes, as well as provision for any other terminal benefits due to employees will be provided for and deducted as liabilities

6 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 of 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

7 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 necessary clarifications may be obtained from the company and their auditors

8 In the matter of provision for depreciation, the following approach will be adopted

- 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 NAV and is not necessary to reckon depreciation according to the written down value methods as claimed by the company for income tax purposes

- If, however, within the preceding five years, the company has switched over from written down value method to 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 informations, 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

- 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

6.2 The calculation of NAV will be recorded, with the necessary details, in the proforma shown in Annexure 1-X

PROFIT EARNING CAPACITY VALUE

- The PECV will be calculated by capitalising the average of the after tax profit at the following rates
- 15 per cent in the case of manufacturing companies
- 20 per cent in the case of trading companies
- 17.5 per cent in the case of intermediate companies', that is to say, companies whose turnover from trading activity is more than 40 per cent but less than 60 per cent of their total turnover.

7 1 While ordinarily the capitalisation rate for a manufacturing company will be 15 per cent, 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

- Where in the case of a listed share, the average of the NAV and the PECV based on 15 per cent capitalisation rate is less than the average market price by a substantial margin, say by over 20 per cent. 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
- Where a company has a high profitability rate as revealed by the percentage of the after tax profit to the equity capital for the company
- Where a company has diversified its activities and is a multy unit company, as a result of which it would be in a position to sustain its overall profit even if any one part of its operations runs into difficulties

In such cases, the capitalisation rate of 15 percent could be liberlised suitably up to maximum of 12 percent with a view to arrive 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 2 The crux of estimating the PECV lies in the assessment of the future maintainable earnings of the business While the past trends in profit and profitability should 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 earning 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

7.3 The provision for taxation, the method of computation of the average profit 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:

7.4. Provision for taxation - For Computation of profit after tax, provision for taxation will be assumed on the following basis :

- **Widely held public limited companies -** Provisions for taxation will be assumed at the current statutory rate under the income tax. If however, the actual liabilities as shown in the audited accounts of the company is more than the current statutory rate, then the actual will be assumed subject to a maximum statutory limit of income tax plus surtax on companies under the Income Tax Act 1961 The expression "actual tax liability" will mean the average of the tax liability (in percentage point) for the preceding three years or the actual tax liability in the latest accounting year, whichever is higher

- **Tea companies** - Provision for taxation will be assumed at 70% in consideration of the fact that on 40% of their profit, they have to pay central income tax, while on the remaining 60% of the profit, they have to pay the state agricultural income tax and that in addition they may have to pay surtax also

- **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 73.50%

- **Private Limited Companies and closely held public companies** - In the case of private limited companies which proposed 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 actual will be restricted to a minimum of 70% This position will hold good for closely held public limited company also (i.e. public limited companies not listed nor proposed to be listed on the stock exchange)

7.5 **Method of computation of average profit** - 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 profit

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

2) Ordinarily, the averaging profit 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 company and/or the fresh issue is of a sizable order or where the profit show erratic variation or where the premium involved is substantial or where the industry concerned is subject to cyclical trends,

e g "Tea Industries" it would be advisable to take into account the profit 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 profit of the last three years can be considered to be normal (thumb rule for determining which could be that the annual variation does not exceeds 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 profit is 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 accounts of the preceding two years also to check that the rising trend in profit is stable. Conversely, if the profit is declining consistently from year to year, it would be advisable to assume the profit of only the latest year because any average - simple or weightage -will give a higher figure than the profit of the latest year, and it will not be rational to assume a higher profit in a situation of consistently declining profit. Here also, it would be advisable to look into the accounts of the five years to take judgment on the trends in profit.

4) If a business has sustained losses in all the three years or even in the latest two years, the PECV will have to be regarded as "nil" because it would not than be realistic to assume that the business would earn profit in the near future But if the business has sustained 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 workout 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 profit of the latest year, than it would

be advisable to assume, as a measure of abundant caution, the profit 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 6 **Treatment of the profitability of the fresh issue of the capital** - In deciding upon the profitability of the additional capital being raised the following factors must be looked into ·

1) 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 industrial license

2) Whether the expansion or the new project is "on the ground" and tangible progress has been made in implementing the project.

3) The forecast of future profit and profitability of the project.

7 7 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 profit upto maximum of 50% of the existing rate of profitability In other wards, maximum will be calculated as under

Fresh capital X existing profit after tax / Existing net worth

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

7 8 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 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 profit will be assured

7 9 The calculation of PECV will be recorded with the necessary details in the proforma shown in Annexure 1-Y

MARKET VALUE

8. The question of market value (MV) acting as a guiding factor for valuation will obviously arise only in those cases where the share being valued are listed on the stock exchange In such cases, the MV will be taken cognisance of in the following manner

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

- The high and low of preceding two years.
- The high and low of each month in the preceding twelve months.

(2)The average market price will be kept in the background as 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 FV will be check against the average market price on the following lines .

- If the average of the NAV and the PECV on 15% capitalisation rate is less than the average market price by about 20% only, then the average will be regarded the FV
- If however, the average of the NAV and the PECV is less than the average market price by substantial margin, say by over 20 %, then PECV 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 the fair value, capitalisation rate will be 8%
- The FV will be determined on the basis of the average of the NAV and reworked PECV.
- Thus, while MV will not be direct "input" in valuation, it will be recognised and made use of in the aforesaid manner while determining the FV of listed share

8.1 The details of the market price and the calculation of the average market price will be recorded in the proforma shown in Annexure 1-Z.

FAIR VALUE:-

9. As indicated in Para 5 above, the final valuation based on best reasonable judgment will be called the FV.

9 1 In the case of companies, the average of NAV and the PECV based on the 15% capitalisation rate will be the starting point for determining the FV. The following principles will be kept in view in arriving at FV.

(1)In the case of listed shares, if the average of the NAV and PECV on 15% capitalisation rate is less than the average market price by about 20% only, then the average will regarded as the FV

(2)If however, the average of the NAV and PECV is less than the average market price by a substantial margin, i.e. by over 20%, than the PECV may be reworked by liberalisation suitably the capitalisation rate of 15% upto a maximum of 8%. The FV will be determined on the basis of the NAV and the reworked PECV

(3)As a matter of prudence , it may be desirable to deduct atleast one year's dividend per share from the average of the NAV and PECV to arrive at the FV A cushion of this order may be required as safeguard against future uncertainties.

(4)Where the PECV is "nil" or negligible, the FV should be limited to half of the NAV If however, the net assets comprise mostly of liquid assets like cash and bank balances or easily realisable bank debts, the FV may be fix upto 2/3 of the NAV and upto the actual cash and the 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 NAV and the PECV should be discounted by atleast 1·15 per cent to take account of the restricted mobility of the share. Para NO 9 2 to 11.6 not relevant

VALUATION ON THE BASIS OF WILLING BUYER-WILLING SELLER CONCEPT:

12 While, as 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.

(1)Small value cases - If the total consideration involved does not exceed Rs. 5 lacs and the shares being transferred do not constitute more than 10% of the total equity share holding 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 possibilities of splitting the share into small value transactions, only one such transaction in the same share should ordinarily be allowed in a period of one year. 12.1 Cases where the FV is close to the price agreed to between the two parties - If the FV 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 settle amongst themselves

GENERAL:

13 It is important to stress the fact that however elaborate and detailed 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 sheet but which will strongly influence the worth of share. Similarly, the account might be "window dress" with a view to presenting a brighter picture of company's working results The guidelines are intended to provide the basic framework for valuation and to minimize 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

13 1 It would be useful to compare the basis of valuation according to this 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 unable us to explain the basis of our valuation to the company concerned.

ANNEXURE 1 - X
NET ASSET VALUE (NAV)

Name of the Company ______________________________

According to the audited balance sheet as at ______________________________

	Rs (Lacs)		Rs. (Lacs)
Total Assets	______	Shareholders fund	______
Deduct all liabilities	______	(1) Equity Capital	______
1 Preference capital	______	(2) Free reserves	______
2. Secured & unsecured borrowings	______	Total	______
3 Current liabilities	______	Deduct contingent liabilities	______
4 Contingent liabilities	______		______
Net worth	______	Net worth	______

Add

(1)Fresh capital Issue at Face Value ______

Total ______

Number of shares including Fresh and bonus issue ______

NAV per share ______

Average profit before tax(on the basis of weighted average) ______

Deduct

Provisions for taxation at ______

Average profit after tax ______

Deduct. Preference dividend ______

Net profit after tax ______

Add Contribution to profit by fresh issue if any ______

Total profit after tax ______

Number of equity share including fresh and bonus issue ______

Earning per share(EPS) ______

Profit Earning Capacity Value (PECV) at 15 % capitalisation rate (i.e. by multiplying EPS by 66) ______

PECV according to the Company's Auditors Report ______

ANNEXURE 1-Y
PROFIT EARNING CAPACITY VALUE (pecv)

Year	Profit before tax	Profit after tax	Dividend declared
1			
2			
3			
4			
5			

ANNEXURE 1-Y

PROFIT EARNING CAPACITY VALUE (**pecv**)

	High	Low	Remarks
1 Year			
2 Year			
3 Latest Year			
4 Monthwise (for preceding 12 Months)			
1			
2			
3			
Average Market Price on the above basis			________