

REALISTIC VALUATION OF SHARES AND THE RE-STRUCTURING OF ACCOUNTING REPORTS IN NIGERIA

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Abstract

Valuation is not an exact science. The value of a shareholding depends on many factors; the nature/size of the shareholding, profitability of the business and its future prospects in the market place at the time of the transaction. The disparity in the prices of shares is due in part to lack of financial information provided by management in their financial statements. Share prices are the market values which reflect what investors place on ownership of security based on company's expected performance. In which case, investors buy into the future of a company; hence, future oriented information should be supplied on a regular basis to the Stock Exchange Commission (SEC), shareholders and potential investors. This notwithstanding, most companies are guilty of the major principle of financial communication. Management should note that investors pay a discount for risks and uncertainty and never a premium. **Keywords:** Valuation, Financial Information, Investors and Stock Exchange Commission (SEC).

Introduction

The prices of securities are no doubt dependent on accounting reports. But evidences abound that such reports have failed to provide a factual base sufficient enough to reflect the true values of securities.

What modern investors need and want to see are corporate objectives, as well as management policies, because share prices are reflective of all relevant and available information. The Stock Exchange Commission (SEC) demands that in addition to the basic information required for listing, regular supply of information must be provided to ensure a more realistic pricing of securities.

This paper recognizes the fact that many companies hoard information and as a consequence, prices of their shares are usually lower than they should be. Such companies ignorantly discount their future cash flows while blaming the SEC for under-pricing their shares.

This paper does not intend to suggest that management should disclose proprietary information, like product or marketing strategies to the public. But instead, to de-emphasize the idea that the conventional accounting models, which emphasize financial performance measures such turnover, earnings and earnings per share are necessarily a reliable measure of a company.

Literature Review

Share capital represents the capital provided by the owners of the business or the interest a shareholder has in a company measured by the sum of money, for the purpose of liability in the first place and of interest. Aje (1988).

This could be a combination of the start-up capital and the retained earnings which results from the accumulated profit. It is important to know how much the shareholders equity is worth on the capital structure of a firm.

The rights and obligations attached to a particular share depend upon the terms agreed at the time of issue or by any subsequent amendment. However, according to Kristen (1975), "there is no definitive formula for computing the value a right will actually have in the open market, for the market can be effected by various non mathematical and non statistical factors".

Why is Share Valuation Necessary?

Valuation of Shares may be required for any of the following reasons:

1. To sell a business or share holding, i.e. in the time of disposal of the share by the shareholders, there is the need to have a justifiable realization from the disposal of the shares.

2. When a private company wishes to go public by obtaining a stock exchange quotation.
3. Mergers and Takeover, i.e. when there are some companies which have a proposal for mergers or takeovers involving private companies.
4. For taxation purposes - The objective is to have a basis for levying relevant taxes, i.e. capital gains, capital transfer tax, stamp duty, etc.

Bases of Share Valuation

Share valuation can either be in income or on asset values. There are two incomes receivable on shares, namely:

1. Dividend income
2. Total income (earnings attributable to each shareholder)

Dividend income is payable out of the attributable earnings and the two will only be equal when the company has a 100% dividend payout ratio. Van-Home (1989). Usually, earnings, dividends and assets form the bases for share valuation.

Valuation can be described as "the assessment of a group of assets or the value of certain claims on those assets; such as claims by creditors, preference shareholders and residual owners". Johnson (1973). There are different methods of valuation. However, financial experts agree that in theory, the capitalization of income is the most sound.

Also, it should be noted that in any form of valuation, the fundamental fact is that the company is regarded as a "going concern". In other words, an existing mixture of assets are being valued.

Financial Information Model

A financial information model is based on discounting or capitalizing a company's cash flow (CF). Van-Home (1989). The discounting process is simply the reverse of compound interest. For example, an investment worth N 1,000 today at 20% annual interest will yield N 1,200 a year from now. On the other hand, by discounting N 1,200 renewable a year hence at 20% gives a current capitalized value of N 1,000.

A company present cash flow is equal to net profit after taxes (NPAT) less capital investment. NPAT is most useful because according to Johnson (1973) "we are dealing with a going concern, it is customary to assume that:

- (1) Overtime cash expenditures on replacement of equipment will about equal the non cash depreciation charges.
- (2) The stream of income will continue for an indefinite period and
- (3) The incomes will be constant".

However, these are assumptions which can be modified. But for the purpose of valuation, they can be made to stay.

NPAT is profit before interest and bookkeeping entries, such as depreciation, which has no effect on taxes to be paid. New capital investment (I) is the increase in total assets minus the increase in non-interest bearing current liabilities, such as creditors and accrued expenses. Thus, present cash flow, PCF = NPAT - I.

On the other hand, future cash flow depends on the amount of new investment; again (I), the expected rate of return (R) and the number of periods (n) in years for which high yielding projects are expected to exceed the associated cost of capital. In which case, four important factors (NPAT, I, R and n) are considered basic to future cash flow. In addition, two other equally important factors should be considered in determining future cash flow. These are: dividend payout ratio and debt ratio.

Investors need to know management's anticipated dividend pay-out ratio; that is, the percentage of NPAT available for payment as dividends to ordinary shareholders. Customarily, what remains of NPAT is ploughed back into the company. The other factor, debt ratio shows the percentage of capital inputs by creditors of a company.

These ratios enable potential investors to make an informed judgment on the size of future investment of a company and hence management's expected cash flow. More importantly, management should inform investors about plans to raise money in the capital market.

The dividend pay-out ratio and debt ratio play a significant role in share valuation; because in the pricing of shares, the discount rate is the blended or overall cost of a company's debt and equity. Since interest is tax-deductible, debt may be less expensive than equity. Van-Home (1989).

There is no doubt that other factors may also come into play in the determination of future cash flow. But these are in the writers' opinion considered secondary. For example, market share may be a corporate objective but this can be achieved only if the rate of return on capital is good. Therefore, rate of return is the major factor while market share is secondary.

Also, considering the following abbreviation in Pandey (1999): PO

= market price (present value) of the price per share D (= expected

dividend $i = 1, 2, 3 \dots n$)

k_s = the minimum required rate of return on the stock given its risk P_s ,

= the anticipated selling price of the stock at time n

g = expected growth rate of dividends. The discounted cash flow model given as

$PO = D_1/(1+k_s)^1 + D_2/(1+k_s)^2 + D_3/(1+k_s)^3 + \dots + D_n/(1+k_s)^n$ is used in the valuation of common stock. It is difficult to use in practice and two problems associated with it, they are:

i. Determination of D_n i.e. the eventual price when the share will be sold.

ii. The formula does not give consideration to forecast all future dividends.

However, it should be noted that the Gordon's constant Growth Dividend Model (www.investopedia) given as: $P_0 = D/(k_s - g)$ is used to overcome the above problems. Example: $D = N2.00$ = net expected dividend per share

$k_s = 14\%$

$g = 10\%$

$PO = N2.00 / (.14 - .10) = N50$ per share Note: The above equation can

be re-written to give *dividend yield on shares* as:

$k_s = D/P_0 + g$ Example: $D =$

$N2.00$, $P_0 = N50$, $g = 10\%$

$k_s = N2.00/N50 + .10 = .14$ or 14%

Note: The term $(D/P_0) =$ dividend yield $= (N2.00/N50) = 4\%$ In this case, g is the "capital gain yield". (Adapted)

The foregoing discounting cash flow model applies generally to publicly traded companies. Other derivatives of the Financial Information Model are:

1. The Price/Earnings Model

This particular model is useful when a company's share is not traded publicly and no market exists for it.

It is calculated by using the following steps:

- i. Determine the P/E ratio for the industry;
- ii. Calculate the EPS of the company
- iii. Multiply the P/E of the industry by the EPS of the company

2. Total Common Equity Model, which uses the Book Value (BV) approach, considers the total assets, total liabilities and total number of ordinary shares as per the company's books.

The BV per Share = (Total Assets - Total Liabilities)/Number of ordinary shares Example: Total Assets = N10 million; Total Liabilities = N4 million; number of ordinary shares outstanding = 3 million BV per share = (N10 million - N4 million)/3 million = N2.00 per share

3. The Preference Share Valuation Model

$$V_p = D_p/k_p$$

Where: V_p = present (market) value of the preferred stock per share

D_p = naira amount of dividends per year K_p = investor's required return on the preferred stock

The preference share valuation model uses the formula

Example: Jambo TeleComs Ltd. preferred stock pays an annual dividend of N4 and has a required return of 10%. What is the price of the stock?

Solution: $V_p = N4 / .10 = N40$ per share

If the effects of inflation are to be incorporated by considering inflation as a negative growth, the formula would become:

$$V_p = D_p / (k_p + r)$$

Where r is the inflation rate.

However, prudent investors compare the market yield to their required yield to make buy or sell decisions and this can be achieved by using the preference share yield formula,

$k_p = D_p / V_p$. Where: V_p = present (market) value of the preferred stock per share

D_p = naira amount of dividends per year

K_p = investor's required return on the preferred stock.

And from the previous example, the current yield on the preferred stock, $k_p = N4 / N40 = 10\%$.

Apart from the fact that preferred stock is valued as perpetuity, i.e. indefinitely, they also differ from the ordinary shares in that they carry certain preferential rights. The common areas where such rights exist are:

Dividend payment: Dividends are a fixed percent of par value - Dividend right

ii. Distribution in liquidation - Capital right

The diminishing importance of preference shares has been attributed to the combined effect of inflation on fixed investments and the unfavourable tax treatment of preference shares compared to debentures. These factors could be responsible for the virtual disappearance of the new issues of this type of shares. (Kristen, 1975).

4. Liquidation Value Model

The Liquidation Value Model assumes that assets are sold at below book value to reflect their poor zero earning power. This is because Liquidation Value of a company is usually less than its economic value as a going concern. From the previous example, using the asset value of 10 million, assume the assets can be sold at a discount of N2 million.

BV per share liquidation = $(N8 - N4) / 3$ million = N1.33 per share.

It should be noted that Liquidation Value Model is a "worse case" scenario valuation assessment.

Limitations of the Cash Flow Model

There is no doubt that immediate and remote environmental factors like new technology, cycles of the economy, competition, government policies etc can undermine the very best of forecasts. Therefore, an investor should be aware of the risks of investing inherent in the future cash flow model in particular. However, management educated guesswork and proper quantification of "all things being equal" should provide a strong basis for investors in forming their opinions about a company.

Standard Accounting Model

A typical accounting model which depicts profitability as Sales - Expenses = Profit/Loss can be misleading, especially when certain items in the financial statements are considered. For example, in the profit and loss account, management may interpret other income or fixed charges in different ways; except where full information is provided for users. Without doubt, the increasing diversification of business, in recent years, makes it more difficult for a company to separate operating income from other incomes because incomes from other sources are lumped together without regard to the major source of operations. Sometimes too, receipts from sales may be reported in the profit and loss account without deducting returns or discounts, which may be charged to expenses, thus inflating sales figures.

Another shortcoming of the accounting model is in the widely divergent methods of depreciation used in arriving at cost of sales. The effect of inventory valuation on this category of cost based on the different methods of valuation is another inherent concern. For example, given the persistent double digit rate of inflation in Nigeria in recent times, reported earnings could be bloated by the use of First In First Out (FIFO) method of inventory valuation. Thus, the investor who relies

too much on earnings per share may be taking too much risk. Whereas, it is from the earnings that such measures as EPS, PE ratio, ROE, etc which are of delight to investors are derived.

Though Earnings Per Share (EPS) may be a better gauge than dividends per share because it influences to a large extent stock market prices. Brealey and Myers (2003). However, it is imperative that investors should consider the timing as well as the components of EPS as provided in the Financial Statement before decisions are made.

Another major distortion of the accounting model's view of EPS in particular, is the unwarranted anxiety it creates when a merger is anticipated. Consider a situation where an acquirer pays for an acquisition with shares at higher price earnings (PE) ratio than his own. For example, AJ Company sells a price earnings ratio per share of 25 and acquires company E, which sells at a ratio of 10. AJ company's EPS will shoot up as AJE Company combined. But if E Company acquires AJ Company, E Company's EPS will fall as EJA Company combined. Does it mean that AJE Company is a better combination than EJA Company when both are virtually the same?

Furthermore, the information in a balance sheet can be interpreted in various ways. Therefore, the balance sheet should not be seen as giving a precisely true and unmodifiable value of a firm. Depending on management's policy, the assets of a firm can be valued either at current market value or at cost. Generally, accountants are prone to valuing fixed assets at cost less depreciation, but this procedure is subjective in nature.

The accounting treatment of capital investments poses yet another serious question. In Nigeria and possibly in some other countries, most companies' research and development and advertising and promotion outlays are expensed in the profit and loss account in the year incurred. Whereas, such huge capital outlays which benefit future periods should be carried as assets in the balance sheet and amortized with the passage of time. Alternatively, they should be kept intact until they become worthless; by which time, they could then be written off.

In all, corporate financial performance measures, which are engendered strictly by annual reports, may not be adequate for valuing shares. However, in Nigeria, they are still considered as prime factors. But in spite of the inherent imperfections and somewhat arbitrary nature of the accounting model, it is useful particularly for evaluating the comparative efficiency of companies overtime. Besides, it is a basic requirement of SEC and it is not being suggested that it should be discarded. Rather, the writers are of the opinion that companies in Nigeria should provide in their annual reports some special financial information models similar to those herein discussed to investors and SEC for use in the determination of share prices. This will enhance superior risk-adjusted corporate performance in the stock market.

Recommendations

There is no doubt that some modest achievements have been recorded by the stock exchange over the years. However, it is being recommended that share prices should not be left to market forces only because of the tendency by unscrupulous operators in the market to:

- i. Manipulate prices of securities by spreading false information to stimulate or give appearance of active dealings.
- ii. Trade either individually or in a group so as to raise or depress prices.
- Hi.* Issue false or deceptive information to induce purchases and sales of securities,
- iv. Peg the prices of securities unduly.

In addition, the SEC must continue to monitor and enforce the legal and ethical codes of conduct which bind the operators of the market.

Concluding Remarks

The cash flow models depict an important relationship between them and share prices than does the standard accounting model and its derivatives. Nevertheless, continuous valuation of old securities in the light of a regular, accurate and rapid flow of information regarding changing values of management, social and economic factors should also provide additional guide for pricing new issues. The quality and integrity of management matter in this regard. This is very important because financial statements are in themselves nothing but summarized accounting reports.

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