PAPER – 20: Financial Analysis and Business Valuation

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Time Allowed: 3 Hours **Full Marks: 100**

Section – A

Answer Question No. 1 which is compulsory

1. (a) (i) ₹1,22,000

FIFO Method

First – 10,000 units sold – Purchased in October at ₹10 =	10,000 × 10 = 1,00,000
Next – 2,000 uits sold – Purchased in November at ₹11 =	2,000 × 11 = 22,000
	₹1,22,000

(ii)

	₹
Sales	75,00,000
Less: variable costs	42,00,000
Contribution	33,00,000
Less: Fixed Cost	6,00,000
Profit	27,00,000

Calculation of Total capital employed

	₹
Equity Capital	55,00,000
9 % Borrowings	45,00,000
Total capital employed	1,00,00,000

$$\text{Return on Investment (ROI)} = \frac{\text{Profit} \times 100}{\text{Total Capital employed}} = \frac{₹27,00,000 \times 100}{₹1,00,00,000} = 27\%$$

(iii) **Calculation of free Cash flow to Firm**

	₹
Sales	1,00,000
Less: Cost	75,000
Less: Depreciation	20,000
Profit Before tax	5,000
Less: Tax at 35%	1,750
Profit after tax	3,250
Add: Depreciation	20,000
Less: Change in net working capital	1,000
Less: Change in capital spending	10,000
Free Cash flow to firm (FCFF)	12,250

(iv)

	(₹ in lakhs)
Combined certify value	90
Value of 'A'	(50)
Value of 'B;	(20)
Synergy gain	20
(-) gains shared to 'A'	12
'B' s share in synergy gain	8

(v) Let the capital be ₹100
Then ROE: ₹15
P/E ratio = 20
Then Market value = 20 × 15 = ₹300

$$\frac{\text{Market Value}}{\text{Book value ratio}} = \frac{300}{100} = 3$$

Ratio is = 3 : 1

(vi) $$\text{Value of Right} = \frac{\text{Number of Right shares} \times (\text{Market Value} - \text{Issue Price})}{\text{Total Holdings (i.e.\% old + New)}}$$

$$= \frac{25 \text{ lakhs Shares} \times (6-5)}{125 \text{ lakhs Shares}} = ₹0.2$$

(b) State whether the following statements are true or false

(i) True
(ii) False
(iii) False
(iv) True
(v) True
(vi) False
(vii) True
(viii) False

Sec- B
Answer Any 5 Question from the following

2. (a) **Comparative balance Sheet of Maharaj Ltd. as on 31.03.2012 and 31.03.2013**

Particulars	31-03-2012 (₹)	31-03-2013 (₹)	Amount of Increase (+) or decrease (-) (₹)	Percentage Increase (+) or decrease (-) (₹)
Current Assets:				
Cash and Bank balance	23,600	2,000	(-) 21,600	(-) 91.50
Debtors	41,800	38,000	(-) 3,800	(-) 9.1
Inventory	32,000	26,000	(-) 6,000	(-) 18.8
Other Current Assets	6,400	2,600	(-) 3,800	(-) 59.4
(A)	1,03,800	68,600	(-) 35,200	(-) 33.9
Fixed Assets:				

Land and building	54,000	34,000	(-) 20,000	(-) 37
Plant and Machinery	62,000	1,57,200	(+) 95,200	(+) 153.5
Furniture	5,800	9,600	(+) 3,800	(+) 65.5
(B)	1,21,800	2,00,800	(+) 79,000	64.9
Long term investment (C)	9,200	11,800	(+) 2,600	(+) 28.3
Total assets (A+B+C)	2,34,800	2,81,200	(+) 46,400	(+) 19.8
Current liabilities (D)	52,400	25,400	(-) 27,000	(-) 51.5
Long term debt (E)	40,000	65,000	(+) 25,000	(+) 162.5
Owner's equity:				
Equity share capital	80,000	1,20,000	(+) 40,000	(+) 50.0
Reserves & surplus	62,400	70,800	(+) 8,400	(+) 13.5
(F)	1,42,400	1,90,800	(+) 48,400	(+) 34
Total Liabilities & capital (D + E + f)	2,34,800	2,81,200	(+) 46,400	(+) 19.8

Comparative balance sheet shows the balance of different assets and liabilities of two different periods of same company and shows absolute increase / decrease of each item in 31.03.2013 over 31.03.2012 and also shows the percentage change. Interpretation of these changes is as follows:-

(i) The current assets of Maharaj Ltd. have decreased by ₹35,200 in the year 2012-13 over 2011-12, whereas current liabilities have decrease by ₹27,000 only. But it has no adverse effect on short term liquidity or on current ratio because current assets have decreased by 33.9% and current liabilities have decreased by 51.5%.

(ii) Cash and Bank balance have decreased by 91.5%. It implies an adverse cash position of the company. The company may face problem in meeting its short-term obligations.

(iii) The long-term debt of the company has increased by 62.5%, whereas its owners' equity has improved by 34% only. It implies that the financial risk (in terms of dependency on outsiders and in terms of contractual obligation) associated with the company has increased significantly during the period under study.

(iv) There has been a substantial increase in the fixed assets by the company. The fixed assets have increased by ₹ 79,000 (64.9%). This is mainly due to significant increase in the plant and machinery of the company. The plant and machinery have increased by ₹95,200 (153.5%). It indicates a remarkable improvement in the production capacity of the company during the study period. Such cost of assets have financed by proprietors fund and long term loan raised. It indicates the long term stability of the business.

2. (b)

Particulars	2011	2012	Changes
(a) Sales (₹)	150,000	2,70,000	(+) 1,20,000
(b) Cost of goods sold (₹)	1,00,000	1,80,000	(+) 80,000
Gross profit (₹) [a – b]	50,000	90,000	(+) 40,000
(c) Units sold	10,000	15,000	(+) 5,000
(d) Selling price per unit (₹) [a ÷ c]	15	18	+3
(e) Cost price per unit (₹) [b ÷ c]	10	12	+2

Statement showing account for changes in profit

Particulars	₹	₹
Changes in profit due to changes in sales: 1. Increase in profit due to increase in sales quantity [Change in sales quantity × Base year's unit selling price = (15,000 - 10,000) units × ₹15]		75,000
2. Increase in profit due to increase in unit selling price [Change in unit selling price × Base year's sales quantity = (₹18 - ₹15) × 10,000 units]		30,000
3. Increase in profit due to increase in price and quantity [Changes in unit selling price × Change in sales quantity = (₹18 – ₹15) × (15,000 - 10.000) units]		30,000
		1,20,000
Changes in profit due to changes in cost: 1. Decrease in profit due to increase in quantity [Change in quantity × Base year's unit cost price = (15,000- 10,000) units × ₹10]	(50,000)	
2. Decrease in profit due to increase in unit cost price [Change in unit cost price × Base year's quantity = (₹12 - ₹10) × 10,000 units]	(20,000)	
3. Decrease in profit due to increase in price and quantity [Change in unit cost price x Change in quantity = (₹12 - ₹10) × (15,000- 10,000) units]	(10,000)	(80,000)
Net Increase in Gross Profit		**40,000**

Note: here, the base year is 2011.

3. (a) Working Note:

	₹	₹
A. Cash flows from operating Activities		
Net profit for the period before taxation & Extraordinary items		20,00,000
+ Depreciation		5,00,000
+ Discount written off		30,000
+ interest on Debentures		3,50,000
+ Decrease in bills receivable		10,000
+ Increase in creditors		5,300
+ Increase in outstanding expenses		6,800
- Profit on sale of Investments		-20,000
- Int. Received on Investment		- 60,000
- Increase in Stock		-1,18,000
- Increase in Debtor (2,08,000 – 2,13,100)		-5,100
- Decrease in B/ payable		-5,000
Cash flow from operating activity before tax and extraordinary item		26,94.000
- Tax paid		-10,50,000
+ Extraordinary item		+90,000
		17,34,000
B. Cash flows from Investing Activities:		
+ Sale proceeds of Investment	3,20,000	

+ Income from Investment	60,000	
Cash from Investment		3,80,000
C. Cash flow from Financial Activities:		
- Interest on debentures	-3,50,000	
-Redemption of profit share (15,000 × 100 + 5% of 15,00,000)	-15,75,000	
+ Issue of Shares 50,000 share (10 + 20% of 10)	+6,00,000	
-Preference Dividend (15,00,000 × 10%)	-1,50,000	
-Equity Dividend paid (5,00,000 + 3,00,000)	-8,00,000	
	-22,75,000	
Cash flow		
Opening cash balance (i. e. as 31.03.2003)		1,96,300
+ Cash flow operating action (WN)		17,34,000
+ Cash flow investment activities (WN)		3,80,000
- Cash flow financing activities (WN)		-22,75,000
Closing cash balance (31.03.2004)		35,300

4. (a) **Balance Sheet as at 31.03.2001**

Liabilities	₹	₹	Assets	₹	₹
Share Capital:			Fixed Assets:		
20,000 equity shares of ₹ 10 each, fully paid up		2,00,000	Land		1,20,000
			Plant & Machinery at cost	3,00,000	
			Less: Depreciation	1,20,000	1,80,000
Reserve & Surplus:			Current Assets:		
General Reserve:			Stock		1,20,000
Balance on 1.4.2000	60,000		Debtors		1,60,000
Add: Transfer during the year	40,000	1,00,000	Cash and Bank		1,20,000
Non-current Liabilities:					
Secured Loan 15% Loan	4,00,000				
Less: Installment paid	2,00,000	2,00,000			
Current Liabilities:					
Creditors	1,20,000				
Provision for Tax	40,000				
Proposed Dividend	40,000	2,00,000			
		7,00,000			7,00,000

Income Statement for the year ended 31.03.2001

Particulars	₹	₹
Sales (Debtors × 12) = (₹ 1,60,000 × 12)		19,20,000
(-) Cost of Goods Sold		14,40,000
Gross Profit		4,80,000
(-) Selling & Distribution Expenses:	1,80,000	
(+) Depreciation	1,20,000	3,00,000
Earnings before Interest & Taxes		1,80,000

Interest		60,000
Earnings before Taxes		1,20,000
(-) Provision for Taxes		40,000
Earnings after Taxes		80,000
(-) Dividend		40,000
Profit Retained		40,000

Working Notes:

(i) Total current liabilities are ₹ 2,00,000 and current ratio is 2 times. Hence total current assets = 2 × ₹ 2,00,000 = ₹ 4,00,000.

(ii) Cash and Bank = 30% of total current assets = 30% of ₹ 4,00,000 = ₹ 1,20,000.

(iii) Stock + Debtors = Total current assets - Cash and Bank = ₹ 4,00,000 - ₹ 1,20,000 = ₹ 2,80,000.
Since gross profit is 25% on sales and since debtors velocity and stock velocity are 12 times, their ratio will be 4:3 in terms of sales and cost of goods sold.
Hence debtors = ₹ 2,80,000 × 4/7 = ₹ 1,60,000 and stock = ₹ 2,80,000 × 3/7 = ₹ 1,20,000.

(iv) Since stock velocity and creditors velocity are the same, creditors will be equal to stock. Hence, creditors = ₹ 1,20,000.

(v) Proposed dividend = ₹ 20% of 2,00,000 = ₹ 40,000.

(vi) Tax rate = 33.33%
Hence, Earnings before Taxes = ₹ 40,000 × 300/100 = ₹ 1,20,000. Earnings after Taxes = ₹ 1,20,000 – ₹ 40,000 = ₹ 80,000.

(vii) Amount transferred to General Reserve = Earnings after Taxes – Proposed Dividend = ₹ 80,000 – ₹ 40,000 = ₹ 40,000.

(viii) Interest Coverage Ratio = Earnings before Interest & Taxes/ interest
Earnings before Taxes + interest / interest = 3
or, (1,20,000 + interest) / interest = 3
or, interest = 60,000
Therefore, Earnings before Interest & Taxes = 3 × ₹ 60,000 = ₹ 1,80,000.

(ix) Gross profit is 12 times the difference between debtors and stock. Hence Gross profit = 12 × (₹ 1,60,000 – ₹ 1,20,000) = ₹ 4,80,000.

(x) Earnings before Interest, depreciation & Taxes = Gross profit - Selling & Distribution Expenses = ₹ 4,80,000 – ₹ 1,80,000 = ₹ 3,00,000.

(xi) Depreciation = Earnings before Interest, depreciation & Taxes - Earnings before Interest & Taxes = ₹ 3,00,000 – ₹ 1,80,000 = ₹ 1,20,000.

(xii) Opening value of Plant & Machinery = 1,20,000 × 100/40 = ₹ 3,00,000. Closing value of Plant & Machinery = 3,00,000 – 1,20,000 = ₹ 1,80,000.

(xiii) Debt service ratio (Earnings after Taxes + depreciation + interest)/ interest and installments = 1 time (₹ 80,000 + ₹ 1,20,000 + ₹ 60,000) = installments + 60,000 or, installments = ₹ 2,60,000 – ₹ 60,000 = ₹ 2,00,000

(xiv) Opening amount of loan = ₹ 60,000 × 100/15 = ₹ 4,00,000. Closing balance = Opening balance – installments = ₹ 4,00,000 – ₹ 2,00,000 = ₹ 2,00,000.

4. (b) The NCAER Study on Corporate Distress Prediction prescribed the following three parameters for predicting the stage of Corporate Sickness:
   (i) Cash profit position (a profitability measure)
   (ii) Net working capital position (a liquidity measure)
   (iii) Net worth position (a solvency measure)

   In the given case, we need to judge the above-mentioned parameters to ascertain the stage of sickness of the company.

   (i) Cash profit = Net profit + (Non-cash expenses/losses debited to Profit & Loss A/c) - (Non-cash Incomes/Gains credited to Profit & Loss A/c)
   Here, Cash Profit = Net Profit + (Depreciation Written Off) + (Preliminary Expenses Written Off) = ₹ [(25.60) + 8 +1.60] = (₹16 crores)

   (ii) Net Working Capital = Current Assets - Current Liabilities
   = ₹ [57.60 - 78.40] = (₹20.80 crores)

   (iii) Net Worth = Share Capital + Reserves & Surplus - Miscellaneous Expenditure - Profit & Loss A/c (Dr.)
   Here, Net Worth = Equity Share Capital - Profit & Loss A/c (Dr.)
   = ₹[20.80 - 40.00] = (₹19.20 crores)

   Prediction about Corporate Sickness: As per NCAER Research Study, out of mentioned three parameters, if any one parameter becomes negative in case of a firm, it can be predicted that the firm has a tendency towards sickness. In the given company, all the three parameters [as calculated under (a), (b) and (c)] show negative value. Therefore, it can strongly be predicted that the company is a sick company and its stage of sickness is 'fully sick'. Immediate necessary drastic revival measures are essentially required for the survival of the company.

5. (a) (i) **Buying a small lot of equity shares:** If the purpose of valuation is to provide data base to aid a decision of buying a small (non-controlling) position of the equity of the companies, dividend capitalisation method is most appropriate. Under this method, value of equity share is given by:

$$\frac{\text{Dividend per share} \times 100}{\text{Market Capitalisation rate}}$$

$$\text{Company A}: ₹\ \frac{2.4}{18} \times 100 = ₹13.33$$

$$\text{Company B}: ₹\ \frac{2.08}{18} \times 100 = ₹11.56$$

   (b) **Buying controlling Interest equity shares:** If the purpose of valuation is to provide data base to aid a decision of buying controlling interest in the company, EPS capitalisation method is most appropriate. Under this method, value of equity is given by:

$$\frac{\text{Earning Per Share (EPS)} \times 100}{\text{Market Capitalisation rate}}$$

$$\text{Company A}: ₹\ \frac{3}{18} \times 100 = ₹16.67$$

$$\text{Company B}: ₹\ \frac{2.6}{18} \times 100 = ₹14.44$$

(ii) Preference Dividend coverage ratios of both companies are to be compared to make such decision.

Preference dividend coverage ratio is given by:

$$\frac{\text{Profit After Tax} \times 100}{\text{Preference Dividend}}$$

$$\text{Company A}: \frac{₹3,00,000}{₹60,000} = 5 \text{ times}$$

$$\text{Company B}: \frac{₹3,00,000}{₹40,000} = 7.5 \text{ times}$$

If we are planning to invest only in preference shares, we would prefer shares of B Company as there is more coverage for preference dividend.

(iii) Yes, the rates will be different for buying a small lot of equity shares, if the company 'A' retains 30% and company 'B' 10% of profits.

The new rates will be calculated as follows:

$$\text{Company A}: ₹\frac{2.1}{18} \times 100 = ₹11.67$$

$$\text{Company B}: ₹\frac{2.34}{18} \times 100 = ₹13.00$$

Working Notes:

1. Computation of earning per share and dividend per share (companies distribute 80% of profits)

	Company A	Company B
Profit after tax	3,00,000	3,00,000
Less: Preference dividend	60,000	40,000
Earnings available to equity shareholders (A)	2,40,000	2,60,000
Number of Equity Shares (B)	80,000	1,00,000
Earning per share (A/B)	3.0	2.60
Retained earnings 20%	48,000	52,000
Dividend declared 80% (C)	1,92,000	2,08,000
Dividend per share (C/B)	2.40	2.08

2. Computation of dividend per share (Company A retains 30% and Company B 10% of profits)

	A	B
Earnings available for Equity Shareholders	2,40,000	2,60,000
Number of Equity Shares	80,000	1,00,000
Retained Earnings	72,000	26,000
Dividend Distribution	1,68,000	2,34,000
Dividend per share	2.10	2.34

5. (b) (i)

Future Maintenable profit	₹3,50,000
Less: Maintenable Normal profit (18,00,000 × $\left(18,0,000 \times \frac{10}{100}\right)$	1,80,000
Super profit	1,70,000

Goodwill = Super profit × (Number of years for which super profit can be maintained)

(ii) If normal rate of return = 18%

Future Maintenable profit	₹3,50,000
Less: Maintenable Normal profit (18,00,000 × $\left(18,0,000 \times \frac{18}{100}\right)$	3,24,000
Super profits	26,000

Goodwill = 26,000 × 5 = ₹1,30,000

6. (a) (i) **Determination of EPS, P/E ratio, ROE and BVPC of A Ltd. and B. Ltd.**

Particulars		**A Ltd.**	**BLtd.**
Profits After Tax	(PAT)	₹ 2,10,000	₹ 99,000
No. of Shares	(N)	10,000	8,000
EPS	(PAT/N)	₹ 21.00	₹ 12.375
Market price share	(MPS)	₹400	₹ 150
P/E ratio	(MPS/EPS)	19.05	12.12
Equity funds	(EF)	12,00,000	8,00,000
BVPS (Book Value Per Share)	(EF/N)	₹ 120	₹ 100
ROE	(PAT/EF)× 100	1 7.5%	12.375%

(ii) **Estimates of Growth rates in EPS for each Firm**

	A	B
Retention Ratio (1 – D/P ratio)	0.6	0.4
Growth rate (ROE × Retention ratio)	10.5%	4.95%

(iii) **Justifiable equity share exchange ratio**

(a) Market price based $\frac{MPS_B}{MPS_A} = \frac{₹150}{₹400}$ = 0.375 : 1 (lower limit)

(b) Intrinsic value based = $\frac{₹200}{₹400}$ = 0.5 : 1 (upper limit)

Since A Ltd. has a higher EPS, ROE, P/E ratio, and even higher EPS growth expectations, the negotiated terms would be expected to be closer to the lower limit, based on the existing share prices.

(iv) **Calculation of Post-merger EPS and other effects**

Particulars			**A Ltd.**	B **Ltd.**	**Combined**
PAT	(i)	(₹)	2,10,000	99,000	3,09,000
Shares outstanding	(ii)		10,000	8,000	13,200*

EPS	(i)/(ii)	(₹)	21.00	12.375	23.41
EPS Accretion (Dilution)		(₹)	2.41	3.015**	—

(v) **Estimate of Post-merger Market Price and other effects**

Particulars			A Ltd.	BLtd.	Combined
EPS	(i)	(₹)	21.00	12.375	23.41
P/E Ratio	(ii)		19.05	12.12	19.05
MPS	(i) × (ii)	(₹)	400	150	446.00
MPS Accretion (Dilution)		(₹)	46	28.40***	

* Shores outstanding (Combined) = 10,000 shares + (0.40 × 8,000) = 13,200 shares.
* EPS claim per old share = ₹23.41 × 0.40 = ₹9.36
EPS Dilution = ₹12.375 – ₹9.36 = ₹3.015

***

MPS claim per old share	₹446 × 0.4)	178.40
Less : MPS per old share		150.00
MPS accretion of B Ltd.		28.40

6. (b) **Computation of net – Asset**

	Amount (₹)
Equity share Capital 10,000 'A' Equity shares at 100 (full paid) 10,000 'B' Equity shares at 100 (₹80 paid) 10,000 'C' Equity shares at 100 (₹ 50 paid)	 10,00,000 8,00,000 5,00,000
 Add: Retained Earnings	23,00,000 9,00,000
Net Assets Add: Notional Calls (10,000 × 20 + 10,000 × ₹50)	32,00,000 7,00,000
Total no. of equity shares	39,00,000

(a) Fully paid shares $= \frac{₹10,00,000}{100} = 10,000$

(b) ₹80 paid up share $= \frac{₹8,00,000}{80} = 10,000$

(c) ₹50 paid paid-up shares $= \frac{₹5,00,000}{50} = 10,000$

Total shares = 30,000

Net Asset Value per share $= \frac{₹39,00,000}{30,000} = ₹130$

∴ Net Asset value for each category

A full paid share = ₹130

B (₹80 paid shares) = ₹130 – 20 = ₹110

C (₹50 paid shares) = ₹130 – 50 = ₹80

7. (a) **The value of copyright can be estimated as follows:**

Year	Stable cash flows (₹)	PV @ 7% (₹)	Volatile Cash flows (₹)	PV @ 10% (₹)
1	60,000	56,075	90,000	81,818
2	60,000	52,406	90,000	74,380
3	60,000	48,978	90,000	67,619
4	40,000	30,516	60,000	40,981
5	40,000	28,519	60,000	37,255
		2,16,494		3,02,053

The value of copyright is
₹2,16,494 + ₹3,02,053 = ₹5,18,547.

7. (b) **Calculation of Economic value Added**

	₹
Net operating profit before tax	50,00,000
Less: tax at 35.875%	17,93,750
Net operating profit after tax	32,06,250
Less: cost of Capital employed (Reg. W. N)	12,00,000
Economic value Added	20,06,250

Economic value added is greatest than zero.
Therefore the company qualifies for the loan

Working Notes:

Calculation of cost of Capital employed

	₹
Avg. Total Assets	1,50,00,000
Less: Avg. Current Liabilities	(30,00,000)
	1,20,00,000

Cost of Capital = Capital employed × Weighted Avg. cost of capital

$= ₹1,20,00,000 \times \frac{10}{100} = ₹12,00,000$

8. (a) Write a short note any four of the following

(i) **EBIT- EPS Indifference Point —** It is one of the basic objectives of Financial Management to design an appropriate capital structure which can provide the highest EPS (Earnings per Share) over the firm's expected range of EBIT (Earnings before Interest & Taxes). EPS is a yard stick to evaluate the firm's performance for the investors. The level of EBIT varies from year to year shows how successful the firm's operations are. EBIT-EPS approach is an important tool for designing the optimal capital structure framework of the firm. EBIT-EPS analysis is widely used by Finance Manager because it provides a simple picture of the consequences of alternative financing methods, however more sophisticated techniques are available.
When two alternative financial plans do produce the level of EBIT where EPS is the same, this situation is referred to as *'indifferent point'*. In case, the expected level of

EBIT exceeds the indifference point, the use of debt financing would be advantageous to maximize the EPS. The indifference point may be defined as the level of EBIT beyond which the benefits of financial leverage begins to operate with respect to earnings per share.

The indifference point between the two financing alternatives can be ascertained as follows:

$$\frac{EBIT - I_1 \quad 1-t}{N_1} = \frac{EBIT - I_2 \quad 1-t}{N_2}$$

Where, EBIT = Earnings before interest and taxes

t = Corporate rate of tax

I_1 = Interest charges in Financing alternative 1

N, = Number of equity shares in Financing alternative 1

I_2 = Interest charges in Financing alternative 2

N_2 = Number of equity shares in Financing alternative 2

(ii) **Common errors in Valuation**

1. Confusion of equity value and enterprise value
2. Failure to properly consider normalizing adjustments
3. Assumption that net income = net cash flow
4. Unsustainable relationship of capital expenditures to depreciation
5. Unsupportable long-term growth rate
6. Lack of tax-affecting for pass-through entities
7. No consideration of adjustments to guideline public company multiples
8. No consideration given to market approach
9. Improper reconciliation of multiple valuation approaches
10. Misapplication of marketability discount studies

(iii) **Replacement Value and realization value.**

Net realizable Value:

The value of an asset that can be realized by a company or entity upon the sale of the asset, less a reasonable prediction of the costs associated with either the eventual sale or the disposal of the asset in question.

Net Realizable Value = inflow of cash from Sale of Asset — expense incurred

Net realizable value is a commonly used method of evaluating an asset's worth in the field of inventory accounting. NRV is part of GAAP rules that apply to valuing

inventory, so as to not overstate or understate the value of inventory goods. **Inventory: Cost or NRV whichever is lower is recorded in accounts.**

Replacement Cost:

The cost to **replace the assets of a company or a property of the same or equal value.** The replacement cost asset of a company could be a building, stocks, accounts receivable or liens. This cost can change depending on changes in market value.

Generally a reserve is created in accounts called replacement reserve which will be utilized at the time replacement of Asset.

(iv) **Various types of Business Acquisition**

Business acquisitions tend to come in one of two types: Assets Purchase or Stock Purchase.

Assets Purchase:

The acquiring firm purchases specific identifiable assets of the business. These assets are perceived as having potential to add value to the acquiring company. In some cases, it may also assume specified liabilities. This helps the acquiring company to reduce the risk of taking on unknown liabilities such as seller's contracts, employees, etc.

The acquiring company is keen on the purchase mode as it can acquire the assets at a comparatively lower price. This potentially reduces future capital gains tax upon a sale of the assets. In addition, it increases the future depreciation cost, thereby reducing income tax.

Stock Purchase:

The acquirer purchases the entire outstanding equity of the target company. It is a method whereby the acquirer purchases the entire company and all assets and liabilities of the business that come with it. Stock purchase does not cause any disruption in the operations which can continue as usual.

This method is popular because of the following reasons:

- Closings are simplified.
- Fewer contract consents and very little paper work is required to transfer specific assets.
- All employees and employee benefits are transferred with the stock sale.

(v) **Financial Modeling**

Financial modeling is the task of building an abstract representation of a real world financial situation. This is a mathematical model designed to represent the performance of a financial asset or portfolio of a business, project or any other investment. This is the process by which a firm constructs a financial representation of some, or all, aspects of the firm or given security. The model is usually characterized by performing calculations, and makes recommendations based on that information.

The model may also summarize particular events for the end user and provide direction regarding possible actions or alternatives.

Financial modeling is the task of building a financial model, or the process of using a financial model for financial decision making and analysis. It is an abstract representation of a financial decision making situation. Financial models are not limited to profit making entities. Non-profits, governments, personal finances - all can be represented by financial models.

Attributes of a Good Model: A model is considered to be good if it has the following attributes—

(i) Realistic - Assumptions, relationships, and inputs must be realistic so that the outputs are useable.
(ii) Error Free - harder than it looks.
(iii) Flexible - This is a two edged sword. Develop the model to be easy and error free, then add elements of flexibility. Experience will tell you when a model gets too complicated and should be segregated into separate models for separate purposes.
(iv) Easy to use - Use clear labels and descriptions.
(v) Easy to understand - A financial model is only as good as the analyst using it.

Uses of Financial Modeling:

Financial modeling is used to do historical analysis of a company's performance, and to do projections of its financial performance into the future. Project finance is another area that lends itself to financial models. A project (such as a real estate investment or a new factory) can be analyzed using a financial model. It does not have to be complete business.

Financial Modeling is not just for the Accountant or Financial Consultant, who are called upon to develop financial projections, but also for business owners and managers. With improved user interfaces and heavy use of graphics, it is now feasible for non-technical people to use a financial model to test options and make decisions based on the projected impact on profits and cash flow.