BUSINESS VALUATION MERGERS & ACQUISITIONS

*Dear Students. The following questions have been taken from the last 10 years' question paper and other different books for your Practice. Endeavour has been made to make this compilation error–free, yet mistakes may have crept in for which I am apologetic. Suggestions are welcome for improving this compilation from every walk of the society. Readers should feel free to write me about their queries at my email **tss_chd@hotmail.com**. Or https://www.facebook.com/pages/Tandon-Commerce-Academy/160054464075436?ref=hl*

Q1. Why do Companies opt for mergers and acquisitions?

1. **Desire for growth:**
   (a) **Growth:** Fundamental idea or motive behind any mergers and acquisitions is the desire for growth, and improved & sustained profitability on the part of the firms.
   (b) **Quicker Growth:** Mergers provide the way for Inorganic growth i.e. growth by acquisitions, (which is much quicker than organic growth) by expanding step by step out of own funds, and investment in new facilities etc.

2. **Synergy Effect:**
   (a) Merger of Companies gives rise to further gains due to Synergy Effect i.e. additional advantage over and above individual capabilities which the merger firm gains.
   (b) Synergy gains may arise due to more intensive utilization of production capacities, distribution networks, engineering services, research and development facilities, data processing systems, etc.
   (c) **Examples of Synergy Gains (Based on Nature of Merger) -**
   - **Horizontal Merger:** Economies of scale are prominent as there is high scope for intensive utilization of resources (merger of Arcelor and Mittal Steels)
   - **Vertical Merger:** Improved co-ordination of activities, lower inventory levels, and higher market power of the combined entity.
   - **Conglomerate Mergers:** Reduction or elimination of overhead expenses.

3. **Diversification:**
   (a) **Meaning:** Diversification refers to the entry into new products /product lines, new services or, new-markets, involving substantially different skills, technology and knowledge.
   (b) **Benefits:** Diversification by Mergers helps achieve efficient capacity utilisation, synergy effect, etc.

4. **Taxation Advantage:** Tax shields arising due to accumulated losses and unabsorbed deprecation can be availed by the merged entity when a firm with accumulated losses and unabsorbed depreciation merges with a profit-making firm.

5. **Efficiency:** Mergers and Acquisitions enable the firm to make the best utilisation of resources and produce better results through combined additional resources in terms of various factors of production.
6. **Impact on Market Share:** Mergers eliminate the competition through Buyouts, enhanced reputation in market place and stakeholders, prevent company's own takeover by a Sick Company.

Q2. What are the different types of Mergers?

1. **Horizontal Merger:** Companies that are in direct competition in the same product lines and markets merge.
2. **Vertical Merger:** Merger of Customer Company and Supplier Company.
3. **Concentric Merger:** Acquisition of a firm in the same general industry but neither in the same line of business as, nor a supplier or customer to, the acquiring firm.
4. **Conglomerate Merger:** Merger of Companies that have no common business areas.
5. **Reverse Merger:** Buying out of larger company by a smaller company.

Q3. What are the different Takeover Strategies?

Apart from tender offers the Acquiring Company can also use the following techniques -

1. **Street Sweep:** This refers to the technique where the acquiring company accumulates larger number of shares in a target before making an open offer. The advantage is that the target company's substantial holding is controlled by the Acquiring Company leaving little choice with the minority.
2. **Bear Hug:** Here the Target Company agrees to a settlement with the Acquiring Company for change of control, when the acquirer threatens to make an open offer.
3. **Strategic Alliance:** This involves disarming the acquirer by offering a partnership rather than a buyout. The acquirer asserts control from within and takes over the target company.
4. **Brand Power:** This refers to entering into an alliance with powerful brands to displace the target's brands and as a result, buyout the weakened company.

Q4. What do you mean by Divestiture and Spin-off?

1. **Spin-off:** Spin-Off is the disposal of firms assets or a specific unit of an existing Company, by creating a new Company, and distributing such assets to the new Company (also known as Demerger).
2. **Divestiture:** Divestiture refers to Spin-off of business unit in the form of an independent Subsidiary Company. Asset divested may be a plant, division, product line or subsidiary.
3. **Methods:** Firms divest themselves of operating units in four ways—
   (a) Sale of a product line to another firm.
   (b) Sale of a Unit to existing management, usually through a Leveraged Buy Out.
   (c) Spinning off the Unit into an independent company.
   (d) Liquidation of the Unit.

Q5. Explain the conditions involved in an Amalgamation in the nature of Merger and Amalgamation in the nature of Purchase.

Amalgamation in the nature of Merger is an one, which satisfies **ALL** the following conditions –

1. **Assets and Liabilities:** All the assets and liabilities of the Transferor Company become, after amalgamation, the assets and liabilities of the Transferee Company.
2. **Shareholders:** Shareholders holding **not less than 90%** of the face value of the equity shares of the Transferor Company (other than the equity shares already held therein, immediately before the imalgamation, by the Transferee Company or its subsidiaries or their nominees) become equity shareholders of the Transferee Company by virtue of the amalgamation.

3. **Consideration = Equity Shares:** The consideration for the amalgamation receivable by those equity shareholders of the Transferor Company who agree to become equity shareholders of the Transferee Company is discharged by the Transferee Company wholly by the issue of equity shares in the Transferee Company, except that cash may be paid in respect of any fractional shares. **–**
4. **Continuity of business:** The business of the Transferor Company is intended to be carried on, after the imalgamation, by the Transferee Company.
5. **Book Values of Assets and Liabilities:** No adjustment is intended to be made to the book values of the assets and liabilities of the Transferor Company when they are incorporated in the Financial Statements of the Transferee Company except to ensure uniformity of accounting policies.

Amalgamation in the nature of purchase is an amalgamation, which does not satisfy any one or more of the conditions specified above.

Q6. Distinguish between Amalgamation in the nature of Merger and Purchase.

Type	Amalgamation in the nature of Merger	Amalgamation in the nature of Purchase
Meaning	There is a pooling of assets and liabilities of both Companies as also the interests of the shareholders and the businesses of the Amalgamating Companies.	One Company acquires another Company, but the shareholders of the Amalgamating Company do not continue to have a proportionate interest in the equity or the business of the combined Company.
Continuation of Business	The business of the Transferor Company is intended to be continued by the Transferee Company.	The business of the Company may not be intended to be continued by the Transferee Company.
Carrying amounts	All Assets, Liabilities, Capital and Reserves represent the sum of the relevant figures of the Amalgamating Companies.	Assets and Liabilities may not be taken up in full by the Transferee Company in total. In effect there is **no pooling** of assets and liabilities.
Participation in Management	There is a continuing participation by the Management of the Transferor Company in the Management of the Transferee Company after the amalgamation.	The Transferee Company takes the role of a dominant party after the Amalgamation.
Method of Accounting	The Pooling of Interests Method is generally used for accounting.	The Purchase Method is normally used for accounting.

Q7. Explain the two methods of Accounting for Amalgamations.

Method	Pooling of Interests Method	Purchase Method
Method	Used in amalgamations in the nature of **Merger.**	Used in amalgamations in the nature of **Purchase.**
Recording of Assets and Liabilities	Assets, Liabilities and Reserves of the Transferor Company are recorded at their **existing carrying amounts,** subject to adjustments for uniformity in accounting policies.	Assets and Liabilities are recorded either at their (a) existing carrying amounts or (b) by allocating the consideration to individual assets on the basis of their **fair values.**

P & L A/c of the Transferor company	Balance of the Profit and Loss Account of the Transferor Company should be – **1.** aggregated with the corresponding balance in P&L A/c of Transferee Company **OR** **2.** transferred to the General Reserve, if any, of the Transferee Company.	Balance in the Profit and Loss Account appearing in the Financial Statements of the Transferor Company, whether debit or credit, loses its identity.
Treatment of Non- Statutory Reserves	Capital or Revenue Reserves should be recorded at their existing carrying amounts and in the same form as at the date of Amalgamation. So, Reserves available for distribution as dividend before the amalgamation, would remain in the same nature, after amalgamation also.	Capital or Revenue Reserves (other than statutory reserves) should not be included in the Financial Statements of the Transferee Company.
Treatment of Statutory Reserves	Statutory Reserves are retained at the existing carrying amount in the books of the Transferee Company.	Statutory Reserves are retained at the existing carrying amount.
Goodwill / Capital Reserve	Difference between the purchase consideration and the amount of Share Capital of the Transferor Company is adjusted against Reserves, in the financial statements of the Transferee Company. There is no Goodwill or Capital Reserve in this case.	Consideration above the net assets of the Transferor Company is recognized as Goodwill, which should be amortised to income on a systematic basis over its useful life, **(normally five years).** Negative value is recorded as Capital Reserve.
Adjustments to Assets and Liabilities	Adjustments become necessary **only** when both companies have conflicting accounting policies. The effect of changes in accounting policies must be disclosed, as per AS - 4.	Adjustments become necessary to – • ensure uniformity in accounting policies, or • record assets not recorded in the books c **f** the Transferor Company e.g. Knowhow or other Intangible Asset, or • record liability not recorded in the books of the Transferor Company e.g. provision for planned employee termination or plan: relocation costs.
Management Intervention	There is no domination by the Management of either of the Amalgamating Companies in recording assets and liabilities.	The Management of the Transferee Company may influence determination of fair values tan assets and liabilities.

Q8. What are the procedural aspects to be complied with in case of Amalgamations?

The procedure for amalgamation normally involves the following steps

1. **Examination of Object Clauses-**
   (a) **Power in MOA:** MOA of the companies entering into Amalgamation arrangement should provide power to enter into such Amalgamation,
   (b) **Object Clause:** Object clause of the Amalgamated company (Transferee Company) should permit it to carry out the business of the Amalgamating Company (Transferor Company),
   (c) **Approval:** If such clauses do not exist, approval has to be sought from the Shareholders, Boards of Directors, and Company Law Board.

2. **Intimation to Stock Exchanges:** Amalgamated and amalgamating companies should inform the Stock Exchanges with which they are registered. From time to time, copies of all notices, resolutions, and orders should be mailed to the concerned Stock Exchanges.

3. **Approval of Proposal by the Respective Boards:** Draft amalgamation proposal should be approved by the respective Board of Directors. The Board of each company should pass a resolution authorizing its Directors / Executives to pursue further.

4. **Application to the High Court:** After obtaining the approval for amalgamation, each company should make an application to the High Court so that it can convene the meetings of Shareholders and Creditors for passing the Amalgamation proposal.

5. **Notice to shareholders and creditors-**

   (a) **Notice to Shareholder:** In order to convene the meeting of Shareholder and Creditors, a Notice and an explanatory statement of the meeting, as approved by High Court, should be despatched by each Company to its Shareholders and Creditors so that they get 21 days advance intimation.

   (b) **Publication in Newspaper:** Notice of the meetings should also be published in two newspapers, one each in English and a local vernacular newspaper.

   (c) **Affidavit:** An affidavit confirming that the above has been done, should be filed with the Court.

6. **Meetings of shareholders and Creditors:**

   (a) **Shareholders Meeting:** Meeting of shareholders should be held by each company for passing the scheme of amalgamation, and atleast shareholders holding 75% of the Voting Power (in each class) must approve the Scheme of Amalgamation.

   (b) **Creditors Meeting:** Meeting of Creditors should be held, where atleast 75% of the Creditors (in value) should approve the Amalgamation Scheme.

7. **Petition to the Courts for confirmation and passing of Court orders:**

   (a) **Petition:** After approval by Shareholders and Creditors, companies involved in the amalgamation should present a petition to the Court for confirming the scheme of amalgamation.

   (b) **Hearing:** Court will fix a date of hearing. A Notice about the same has to be published in two newspapers. It has also to be served to the Regional Director, Company Law Board.

   (c) **Order:** After hearing the parties concerned and ascertaining that the amalgamation scheme is fair and reasonable, the Court will pass an order sanctioning the same. Court is empowered to modify the scheme and pass orders accordingly.

8. **Filing the order with the Registrar:** Certified true copies of the Court order must be filed with the Registrar of Companies within the time limit specified by the Court.

9. **Transfer of assets and liabilities:** After the final orders have been passed by both the High Courts with effect from the appointed date, all the assets and liabilities of the Amalgamating company will, have to be transferred to the amalgamated company.

10. **Issue of Shares and Debentures:** Amalgamated Company, after fulfilling the provisions of the Law, should issue Shares and Debentures of the Amalgamated Company. The new Shares and Debentures so issued will then be listed on the Stock Exchange.

Q9. Write a note on Diversification and Divestment strategies.

1. Diversification Strategy:

   (a) Meaning:

   - Diversification refers to the entry into new products /product lines, new services or new markets, involving substantially different skills, technology and knowledge.

- **Example:** Reliance foraying into Retail Business (Reliance Fresh), Bharti Group foraying into Insurance Business (Bharti AXA Insurance) etc.

(b) Reasons:

- **Growth and Profitability:** Diversification offers greater prospects of growth and profitability. Growth and profitability is not just restricted to improving the margins and customer base in an existing line, but also looking for and newer opportunities and challenges. **Example:** Reliance Industries Ltd's foray into telecom.
- **Capacity Utilisation:** Firms which have excess capacity or capability in manufacturing facilities, investible funds, marketing channels, competitive standing, market prestige, etc. can diversify into new lines of activity. **Example:** Tata's foray into Passenger Car segment, from its Truck Manufacturing facilities.
- **Synergy:** Sales and profits of existing products can be improved by adding suitably related products or new ones, because of linkages in technology and/or in markets.

2. Divestment Strategy:

(a) Meaning:

- Divestment Strategy involves the sale or liquidation of a portion of business, or a major division, profit centre.
- Divestment is a part of a rehabilitation or restructuring plan, and is adopted when a turnaround has been attempted but has proved to be unsuccessful.

(b) Reasons:

- Acquired business proves to be a **mismatch** and cannot be integrated within the Company.
- **Negative cash flows** from a particular business create financial problems for the whole Company.
- Inability to cope with the prevailing **severe/ intense competition.**
- **Inability to invest** in the technological upgradation required to survive in business.
- Availability of a **better alternative** for investment.
- Divestment is also done to focus in one area and channelise the resources to a single purpose, than diluting the focus and purpose in different directions.

Q10. What are acquisitions or takeovers? Are takeovers and amalgamations the same?

1. **Meaning:** Takeover means gaining of control by one Company (Acquiring Company) over another Company (Target Company), by means of acquisition of controlling interest in the shares of the target company,

2. **Types:** Takeovers can be of two types —

(a) Friendly Takeover: Where the takeover process is accepted by the management of the target, who also take part in the process.

(b) Hostile Takeover: Where the acquiring company tries to takeover the target despite opposition from the management against such takeover.

3. **Takeover vs Amalgamations:**

Particulars	Acquisition / Takeover	Amalgamation
Governing Law	SEBI Takeover Regulations	Companies Act, 1956

Nature	Involves gaining control over the assets of the Company by holding controlling interest in the Target Company.	Involves direct control over the assets of the target by absorbing the Company.
Result	Takeover does not liquidate the Target Company.	Selling Companies will be liquidated pursuant to Amalgamation.
Transfer of Assets and Liabilities	Assets and liabilities of the Target are not transferred to the Acquiring Company.	Assets and liabilities are transferred.
Involvement of High Court	Scheme of acquisition / takeover does not require High Court's approval.	Scheme of Amalgamation or arrangement requires High Court's Order.

Q11. What do you mean by Leveraged Buyouts (LBOs)? What are the risks involved?

1. **Meaning:** Leveraged Buy-Out (LBO) is an acquisition of a Company in which the acquisition is substantially financed through Debt.
2. **Management Buy-Out (MBO):**
   (a) When managers buy their Company from its owners employing debt, the LBO is called Management Buy-Out (MBO).
   (b) It is the purchase of a business by its Management who when threatened with the sale of its business to third parties or frustrated by the slow growth of the company, step in and acquire the business from the owners, and run the business for themselves.
3. **Extent of Debt Financing:** Debt funds form around 80% of the value of acquisition. Such debt is obtained on the basis of the Company's future earnings.
4. **Settlement to Seller:** LBO generally involves settlement of cash to sellers.
5. **Security for Debt:** Large part of the borrowing is secured by the Firm's Assets, and the lenders take a portion of the Firm's Equity.
6. **Risk in Leveraged Buy-Outs:** Success of Buy-Outs depends on - (a) the ability to improve the performance of the unit, (b) contain its business risk, (c) exercise cost controls and (d) liquidate disposable assets. If these things are not addressed, high fixed financial costs will jeopardize the venture.
7. **LBO Targets:** To be a target of LBOs, a firm should have the following attributes —
   (a) Should be operating in a high growth market with a high market share.
   (c) High potential to grow fast and a capability to earn superior profits.
   (d) Demand for the Company's product should be predictable to a great extent, to measure its expected earnings more reliably.
   (e) High liquidity, high profit potential, and low operating risk.

Q12. Explain the Takeover by Reverse Bid.

1. **Meaning:** It is the act of a smaller company gaining control over a larger one.
2. Features:
   (a) **Control to Management of the Larger Company:** In Reverse-Takeover, control goes to the shareholders (and usually management) of the company that is formally the target of the bid i.e. Management of the larger company.

(b) **Purchase of Listed Company by Unlisted Company:** Reverse takeover is also applicable to the purchase of a listed company by an unlisted company with control passing to the shareholders and management of the unlisted company. This is known as a 'back door listing'. A Reverse Takeover will take place byway of a pure equity acquisition, also called a **Share Swap.**

3. **Tests for identifying Takeover by Reverse Bid:**
   (a) Assets of the transferor company (Selling Company) are greater than that of the transferee companv (Buying Company).
   (b) Equity Capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital.
   (c) Change of control in the transferee company will be through the introduction of minority holder or group of holders.

Q13. Explain the term Demerger.

1. **Meaning:** Demerger refers to a situation where pursuant to a scheme for reconstruction / restructuring, an undertaking is transferred or sold to another purchasing company or entity.
2. **Status of Transferee Company:** Even after demerger, the transferring company continues to exist and carries on business.
3. **Suitability:** Demerger is used as a suitable scheme in the in the following cases —
   (a) Restructuring of an existing business.
   (b) Division of family managed business.
   (c) Management Buy-Out.

Q14. What are the reasons for failure of Mergers and Acquisitions?

The reasons for failure of Mergers and Acquisitions are —

1. **Risk of Diversification:** Wrong venturing into the seemingly profitable areas in an urge to make hugt profits through diversification. Such ventures not only end up making loss, but also proves fatal for the existing set up.
2. **Lack of Integration:**
   a) Success of Amalgamation depends heavily on the proper post-acquisition integration of two different organisations. Integration may relate to integration of information systems, management systems etc.
   b) Improper integration may relate to loss of data, generation of information which cannot be relied upon, loss of productive resources etc.
3. **Loss of Key employees:** Mergers are generally followed by loss of some of the key employees due to —
   a) Retrenchment policy of the newly merged firm.
   b) Excess employment (i.e. the employee requirement of the newly merged firm is low when compared to the total employees of the two firms put together).
4. **Differences in Corporate Culture:** Corporate culture clashes is one of the common features which arise in case of mergers and acquisitions because two or more firms with different corporate strategies and goals have combined into one single merged firm.
5. **Lack of Due Diligence:** Sometimes it may happen that the firms fail to properly estimate the profits and benefits that are possible to accrue due to the effect of merger. The problems are —

(a) Seller may exaggerate the worth of intangible assets (Brand Image, Technical Know-How, Patents and Copyrights etc).
(b) Accounting reports may be window-dressed.
(c) Buyer may not be able to assess the hidden problems and contingent liabilities or simply brush them aside because of its infatuation with the target company.

6. **High Premium paid for Company:** The cost of merger may overshoot the actual benefits derived from the merger.

Q15. Explain the causes of Industrial Sickness in India.

Internal Causes:

(a) Planning:

Technical Shortcomings	• Inadequate Technical Know-How • Vocational Disadvantage • Outdated Production Process
Economic Viability	• High Cost of Inputs • High break-even point • Uneconomic size of project • Under estimation of the financial requirements • Unduly large investment in fixed assets • Over estimation of demand
Labour Issues	• Poor labour relations • Lack of trained / skilled labour or technically competent personnel.
Marketing Management	• Dependence on a Single Customer / Limited Customers • Dependence on Single Product / Limited Products • Poor sales Realization • Defective Pricing Policy • Booking of large orders at fixed prices in an inflationary market • Weak market feedback and market research • Lack of knowledge of marketing techniques • Unscrupulous sales / purchase practices
Financial Management	• Poor Resources management and financial planning • Faulty Costing • Liberal Dividend Policy • General Financial indiscipline and application of funds for unauthorized purposes / • Deficiency of funds • Un-favourable gearing or keeping adverse debt-equity ratio • Inadequate Working Capital • Absence of Cost Consciousness
Administrative Management	• Over Centralization • Lack of Professionalism • Lack of feed-back to the management

(b) **Implementation:** Cost over runs resulting from delays in getting licenses / sanctions, etc., inadequate mobilization of finance.

Production Management	• Inappropriate Product Mix • Poor Quality Control • High Cost of Production • Poor Inventory Management • Inadequate Maintenance and Replacement • Lack of timely and adequate modernization • High Wastage, poor capacity utilization
Labour Management Relations	• Excessively High Wage Structure • Inefficient handling of Labour Problems • Excessive Manpower • Poor Labour Productivity • Lack of Proper Management Information System • Lack of timely diversification • Excessive Expenditure on Research and Development • Dissension within the management, incompetent and dishonest management

2. **External Causes:**

(a) **Government Controls and Policies, etc.:** Government price controls, fiscal duties, abrupt changes in Government policies affecting costs / prices / imports / exports / licensing.

(b) **Procedural Aspects:** Procedural delays on the part of financial /licensing/other controlling or regulating authorities line Bank, RBI, Financial Institutions, Government departments, Licensing Authorities, etc.,

(c) **Market Constraints:** Market saturation, revolutionary technological advances rendering the products obsolete, and recession – fall in domestic / export demand.

(d) **Extraneous factors:** Natural calamities, Political situation (domestic as well as international) and strikes and multiplicity of labour unions etc.

Q16. Discuss the main features of Green Field Privatization

1. **Privatisation:** Privatization is a process of reducing the involvement of the State in the nation's economic activities by inviting and increasing the participation of private players.
2. Greenfield Privatisation: It can take two forms —
   (a) Permitting private players to operate in areas hitherto unavailable to them
   (b) Facilitating Private Players to operate in areas hitherto unexplored, wherein there are no established set up.
3. **Indian Scenario:** Greenfield Privatization was promulgated and private participants were made to play a major role in the Indian Economy in a big way and was implemented through —
   (a) Delicensing of major industries
   (b) Decline in number of areas reserved for public sectors, and
   (c) Encouraging Foreign Direct Investments
4. **Features:** Green Field Privatisation is generally characterized by the following —
   (a) **Influx of Foreign Capital:** There is a huge inflow of foreign funds into the economy with wider participation by investors across different countries.

(b) **Increase in Competitiveness:** Privatisation is marked by significant increase in competition and giving a wide variety of choice to final consumers.

(c) **Efficiency:** Though not always, increase in competitiveness forces Company to look at cost reduction mechanism through either increasing efficiency, effective utilization of resources, identifying alternative sources of energy, materials etc.

(d) **Tax Benefits:** Sops in the form of tax benefits, greater degree of independence etc. to the enterprises.

Q17. Explain the Multiple Discriminant Analysis.

Meaning: Multiple Discriminant Analysis (MDA), propounded by Edward Altman, combine different indicators of financial performance and solvency position into a single measure of the probability of sickness, failure or insolvency.

Need for MDA:

(a) Different factors contribute to the success or failure of a Company - Earnings, Turnover, Profit Margin etc.

(b) There are different indicators which reflects the direction in which the Company is going - Liquidity Ratios, Turnover Ratios, Profitability Ratios etc.

(c) However, all these are standard alone ratios / factors, and do not provide the appropriate picture on a wholesome basis. An investor is also not sure as to what weightage to be assigned for different factors.

3. **Weights:** MDA considers the following five factors (ratio of different items to the Assets) on a weighted basis to ascertain the Discrimant Score (Bankruptcy Index) of a Firm —

Factor	Notation	Weights
(a) Ratio of Net Working Capital to Total Assets	X_1	1.20
(b) Retained Earnings to Total Assets	X_2	1.40
(c) Operating Profit (EBIT) to Total Assets	X_3	3.30
(d) Market Value of Equity to Book Value of Debt	X4	0.60
(e) Turnover to Total Assets	X_5	0.99

$Z = 1.20\ X_1 + 1.40\ X_2 + 3.30\ X_3 + 0.60\ X_4 + 0.99\ X_5$, where, Z is the overall index. Weights are assigned to different indicators on the basis of their significance from bankruptcy evaluation.

4. **Evaluation:** Evaluation is done based on the Weighted Sum of the above factors and comparing the sa to the cut off figure of 2.675.

Value of Z is	Inference
Greater than 2.675	Financially Sound. Non-Bankrupt Region
Less than 2.675	Bankruptcy Region.

Q18. What are the various Valuation Techniques?

The various Valuation Techniques for valuing potential acquisitions are—

1. Asset Based Valuation
2. Yield based Valuation-
   (a) Earnings Capitalisation Method.
   (b) Return on Capital Employed.
   (c) Price Earning Multiple.
   (d) Discounted Cash Flow Approach to Valuation.

Q19. What is Asset Based Valuation technique? Explain.

Step	Procedure
1	Compute Value of Assets (and Goodwill) as per the principles of ascertainment, laid down below.
2	Determine the value of all Liabilities, and claims of Preference Shareholders.
3	Net Assets available to Equity Shareholders = Value of Assets **Less** Amount of Liabilities. Value per Equity Share = $\frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}}$

1. **Assets:** The following principles are considered while arriving at the Net Assets available to Equity Shareholders -

Assets	Basis of Valuation
Tangible Fixed Assets	Valued at Current Cost i.e. Current Purchase Price or the price to be paid b firm to acquire such assets at their present location and condition.
Intangibles	Valued at Current Cost. Goodwill appearing in the books is eliminated and valuation is taken into consideration.
Investments	Quoted investments are taken at Market Price. Unquoted Investments rru taken at Book Value after adjusting for known losses, if any.
Inventories	Finished Goods are taken at Market Price / Realizable Value. Raw Material, Stores and WIP should be taken at Cost on a conservative r Allowance shall be made for any obsolete, unusable or unmarketable stocks
Debtors	Taken at realisable value i.e. after making appropriate allowance for Ba; Doubtful Debts.

Assets	**Basis of Valuation**
Development Expenses	These arise (a) when a new Company is in the process of executing its project and ***I*** when an existing Company is in the process of expansion of existing product lines or diversification into new product lines. Such expenses appear in* the Balance Sheet as Capital Work -In - Progress. The value of Capital WIP should be taken at Current Cost, and not at the Balance Sheet Value.
Misc. Expenditure & Losses	All Fictitious Assets appearing under this head should be ignored.

2. **Liabilities:** Liabilities should be determined at their redemption amounts, considering discount/ premium if any, involved in redemption. The following liabilities should be deducted -
   (a) All Short Term (Current Liabilities) and Long-Term Liabilities (Debentures, Loans etc) including Outstanding and Accrued Interest.
   (b) Provision for Taxation.
   (c) Liabilities not provided for in the accounts i.e. Contingent Liabilities which have crystallised now.
   (d) Liabilities arising out of prior period adjustments, which would reduce profit of earlier years, after netting off those items which would increase profit.
   (e) Preference Share Capital including Arrears of Dividend and Proposed Preference Dividend.
   (f) Proposed Equity Dividend (if the objective is to determine ex-dividend value of Equity Shares).

Q20. List the merits and demerits of Net Assets Basis for valuation of Shares.

1. **Suitability / Merits:** Net Assets basis may be adopted in the following situations -
   (a) For Companies using Capital Intensive technology.
   (e) For valuation of Shares under Taxation Laws, e.g. Wealth Tax Act.
   (c) For Companies whose accounts do not serve as a guide for future profit.
   (d) For Companies reporting losses and there are no prospects of earning any profit in the future.
   (e) For Companies which are in the course of winding-up / liquidation.
   (f) For Companies where there is no reliable evidence of future profits due to violent fluctuation in the business or disruption of business.
   (g) For Statutory Valuation under various Acts.

2. **Demerits:** The disadvantages of Net Assets basis are -
   (a) There is subjectivity in determining the values of various assets, particularly Goodwill.
   (b) This method is not appropriate if the Company is a going concern.
   (c) This method does not recognise the earning power of the business. For service sector enterprises, earning capacity is dominant in determining Value of Share, rather than the amount of assets

Q20. List the merits and demerits of Net Assets Basis for valuation of Shares.

Suitability / Merits: Net Assets basis may be adopted in the following situations -

a. For Companies using Capital Intensive technology.
b. For valuation of Shares under Taxation Laws, e.g. Wealth Tax Act.
c. For Companies whose accounts do not serve as a guide for future profit.
d. For Companies reporting losses and there are no prospects of earning any profit in the future.
e. For Companies which are in the course of winding-up / liquidation.
f. For Companies where there is no reliable evidence of future profits due to violent fluctuation in the business or disruption of business.
g. For Statutory Valuation under various Acts.

Demerits: The disadvantages of Net Assets basis are -

- There is subjectivity in determining the values of various assets, particularly Goodwill.
- This method is not appropriate if the Company is a going concern.
- This method does not recognise the earning power of the business. For service sector enterprises, earning capacity is dominant in determining Value of Share, rather than the amount of assets.

Q21.. Explain the Dividend-Yield Method for Valuation of Shares.

Step	Procedure
1	Compute the Future Maintainable Dividend Rate or Dividend Rate for the current year, of the Company. Company's Dividend Rate = Distributed Profit ÷ Paid up value of Equity Capital.
2	Determine the Normal Rate of Dividend / Market Dividend Expectations for the Industry as a whole.
3	Adjust the Industry Normal Rate of Dividend for Risk Factors applicable to this Company e.g. **low** coverage ratio, high debt-equity ratio, low asset backing ratio etc.
4	Value per Share = Paid up value per Share × $\dfrac{\text{Company's dividend rate}}{\text{Industry divided rate (adjusted for risk factors}}$

Note: This approach is suitable only for - (a) purchase of £mall lot, or (b) use by Mutual Fund Manager case of dividend stripping. This method is not suitable for valuation of controlling interest.

Q22. Explain the Earnings Yield Method for Valuation of Shares.

Step	Procedure
1	Compute the Future Maintainable Operating Profits (FMOP) available to Equity Shareholders of Company (after deducting Preference Dividend).
2	Determine the Normal Rate of Return / Market Return Expectations for the Industry as a whole.
3	Adjust the Industry Normal Rate of Return for Risk Factors applicable to this Company e.g. low coverage ratio, high debt-equity ratio, low asset backing ratio etc.
4	Compute capitalized value of Future Maintainable Operating Profits = FMOP -4- Risk Adjusted NI
5	Compute Total Assets available to Equity Shareholders = Step 4 + Non Trade Investments.
6	Value per Equity Share = $\frac{\text{Total assets available to equity shareholders i.e step 5}}{\text{Number of equity Shares}}$

Note: Dividend Capitalisation and Earnings Capitalisation Methods will have the same NRR, when Company has a 100% dividend payout ratio.

Suitability: This approach is suitable in the following situations -

(a) Acquisition of controlling interest as against small lot purchases.

(b) Valuing shares when the shareholder is interested in wealth creation rather than receipt of dividends.

(c) Companies using labour intensive methods / units in service sector where the earning power is dominant rather than book values of assets.

(d) Company is a going concern and there are no plans of liquidation in the near future.

(e) Information regarding the factors that affect the Future Maintainable Profits is available and identifiable.

(f) There are less fluctuations in the business or no disruption of business so that a realisable evidence Future Maintainable Profits is available.

(g) Financial Statements serve as a useful tool in predicting the future profits.

(h) Market information is readily available to estimate the Normal Rate of Return or Capitalisation Factor.

Q23. Explain the Productivity Factor method of valuing shares.

Step	**Procedure**
1	Compute Past Average ROCE of the Company. ROCE = PBIT ÷ Capital Employed. Either simple or weighted average ROCE may be determined.
2	Determine the Capital Employed by the Company on the Valuation Date.
3	Compute Future Maintainable Gross PBIT = Capital Employed on Valuation Date × Past Average ROCE i.e. Step 2 × Step **1.**
4	Compute Future Maintainable Operating Profits available to Equity Shareholders = Step 3 **Less** Interest on Debt, Tax and Preference Dividend.
5	Determine the Normal Rate of Return / Market Return Expectations for the Industry as a whole and make risk related adjustments thereto.
6	Compute capitalized value of Future Maintainable Operating Profits = FMOP -h Risk Adjusted NRR
7	Compute Total Assets available to Equity Shareholders = Step 6 + Non Trade Investments.
8	Value per Equity Share = $\frac{\text{Total assets available to equity shareholders i.e step 7}}{\text{Number of equity Shares}}$

Note: This method is only a variant of the Earnings Capitalisation Method.

Q24. Earnings on Investment (ROI) is not an adequate measure for judging the financial performance of a business undertaking. Comment.

1. **Earnings and Investment Based:** ROI is based on earnings and investment, which are subject to .nous manipulations or decisions of management on various accounting policies, such as depreciation, nventory valuation, treatment of provisions, etc. Such decisions affect the amount of the reported profit "-".at are generally arbitrary.

2. **Method of Computation of ROI:**
   - **(a)** There are various bases for calculating both profit and investment i.e. including Intangible Assets, excluding Intangible Assets, Gross Fixed Assets or Net Fixed Assets.
   - **(b)** ROI on its own cannot be used to judge the financial performance. It should be compared with certain bench mark figures such as Industry Average or the Company's previous year performances.
   - **(c)** The difficulty of identifying the appropriate or comparable benchmark figure is aggravated by presence of large number of bases, which can be manipulated.

3. **Cut on R&D:**

1. If ROI alone is taken as a basis forjudging the financial performance, Managers may cut down costs on Research and Development, which are done with long term prospects in mind.
2. Due to this, focus will be on generation of short term profits, and the management might lose sight of the long term visions, and might lose out to its competitors in the long run.
3. Cutting down on such costs without any justification, will adversely affect the profitability of the firm in the long run, though in the short run ROI may indicate better performance.

4. **Focus on Ratio:** ROI being a ratio, the emphasis is on improvement in the ratio as such irrespective of the fact whether profits in absolute term increase or not. Management may resort to repayment of Capital, without exploring any further investment alternatives.
5. **Result of actions of Past Managers:**
   - (a) Many times the ROI is not the result of the performance of the present managers. It is generally due to the actions of the past management.
   - (b) Therefore, the present management cannot be held responsible for the current low ROI or credited with the current high ROI.

5. **Conservatism:** ROI introduces the element of conservatism and gives undue significant to capital resources whereas profits may be the result of the contribution of various other inputs chiefly human resources. Their role is not clearly visible in the computation of ROI.

6. **Measure of Performance Evaluation:** The manager who is satisfied with the present ROI may not take initiative to expand due to fear of decrease in ROI. This would mean that the firm has not been able to exploit available opportunities

Q25. Explain the Price Earning (PE) Multiple Method for valuation of Equity Shares.

Step	Procedure
1	Compute EPS of the Company on the Balance Sheet date or Future Maintainable EPS.
2	Ascertain the PE Ratio of the Industry as a whole. PE Ratio = Market Price per Share ÷ Earnings Share. Risk adjustments may be made in appropriate situations. **Note:** PE Ratio should be ascertained the representative Companies in the industry and not for the Company whose shares are being valued.
3	Value Per Share = Company's EPS × Risk Adjusted Industry PE Ratio i.e. Step 1 × Step 2

Note: It is only a variant of Earnings Capitalisation Method. Generally NRR may be taken as 1 ÷ PE Rat

Q26. Write short notes on Discounted Cash Flow Analysis.

1. **Basis:** Under Discounted Cash Flow Technique, value of the assets of an entity is the present valu the future cash flows that arise out of such asset.

2. **Factors Considered:**

   (a) **Projection Period:** Period considered for the analysis is the natural business cycle. Projection period varies from organisation to organisation and industry to industry. In general, the period considered under discounted cash flow technique is 5 to 10 Years.

   (b) **Cash Flow and Reinvestment Amount:**
   - Projection of cash flow should be made discretely by considering all relevant factors sue] expected demand, Government policies with reference to the product, etc.
   - Cash flow should be measured on before tax basis, and suitable adjustments should be mad consider reinvestment amount (i.e. expected dividend distribution, reinvestment opportui etc.) required to make the business grow.

   (c) **Terminal Value:** This is the remaining value of the assets of the business at the end of the proje period. This can be computed using —
   - **Multiplier Approach:** Application of Price Earnings Multiple (PEM) to the final year's income.
   - **Perpetuity Approach:** Capitalisation of the final year's projected cash flow by the discount treating that final year's cash flow as an annuity i.e. recurring for infinite period.
   - **Book Value:** Terminal Value can be estimated by multiplying the forecasted book value of **capital** by an appropriate Market-to-Book Value Ratio (P/BV). The Current Market to Book Value F may be taken as a base.

   (d) **Discount Rate:** Discount rate used in calculating the present value of each year's cash flow should represent the actual level of risk associated with the Firm, inflation impact on the economy, and other related factors.

3. **Steps in Valuing Firm under Discounted Cash Flow Method:**

   (a) **Computation of Free Cash Flows** for the forecast period. Free cash flows represents, operating cash flows available for servicing providers of finance, i.e. Equity and Debt.

   (b) **Determination of Discount Rate** for estimating present value. In general, the cost of capita appropriate discount rate.

   (c) **Computation of Present Value** of cash flows. The free cash flows are discounted using the appropriate discount rate.

   (d) **Estimation of Terminal Value,** i.e. Present value of cash flows occurring after the forecast **period.**

   (e) **Value of Firm** = It is the aggregate of the present value of free cash flows and the terminal **value.**

Q27. Explain the significance of the mode of discharge of consideration i.e. by way of stock or by way of cash. When should a Company prefer discharging its purchase consideration by cash, and when should it choose stock as preferred discharge mode?

1. Point of Distinction:

   (a) **Cash Discharge:** Cost of acquisition is independent of the gains of the acquisition, if compensation is paid in cash. This is because, once cash is paid, there is no relationship between the Merged Company and the Shareholders of the Selling Company. Therefore, subsequent profitability has no bearing on the cost of acquisition.

(b) **Stock Discharge:** If the compensation is paid in stock, the cost of acquisition is dependent on the gains of the acquisition. This is because, the Shareholders will continue to have stake in the newly merged entity as well. Therefore, they would require further returns in the form of dividends and price increase (cost of equity), which will add up to the cost.

2. Situations of appropriate mode of disposition of Compensation:

Situation	Compensation
Acquiring Firm's stock is **overvalued** relative to the acquired Company's Stock	Stock
Taxability in the hands of Shareholders of Acquired Firm	Cash
High risks associated with the Stock of Acquired Firm	Cash

Q28. How is Exchange Ratio in case of Mergers and Acquisitions computed?

The formula to compute the Exchange Ratio is = $\frac{[(V_S+G_S)\times S_B]}{[(V_B+G_B)\times S_B]}$

Where,
- V_S = Value of Selling Company before Merger
- V_B = Value of Buying Company before Merger
- G_S = Share of Selling Company in the Gain on Value due to Merger
- G_B = Share of Buying Company in the Gain on Value due to Merger
- S_S = Shares outstanding in Selling Company before Merger
- S_B = Shares outstanding in Buying Company before Merger

Note: Total Gain [G] = Value of Merged Entity
Less Value of Selling Company
Less Value of Buying Company

Q29. What do you mean by Sustainable Growth Rate?

1. **Meaning:** Sustainable Growth Rate (SGR) is the maximum growth potential of a Company, given its current financial conditions, by examining the interaction between the following policy goals —
   (a) Target Sales Growth
   (b) Target Return on Investment (Net Assets)
   (c) Target Dividend Payout
   (d) Target Debt-Equity Structure

2. **Assumptions:** Sustainable growth rate is based on the following assumptions —
   (a) Assets of the Firm will increase proportionally to Sales.
   (b) Net Profit is a constant proportion of Sales.
   (c) Dividend Payout ratio and the debt-equity ratio of the Tirm are given.
   (d) Firm will not raise external Equity Capital.

3. Mathematical Notation:

   Sustainable Growth Rate (g) = $\frac{\text{Increase in Assets}}{\text{Assets at the Beginning of the Year}}$

$$\frac{\text{Increase in Assets}}{\text{Increase in Assets Assets at the Year End}}$$

$$\frac{\text{Net Margin} \times \text{Retention} \times \text{Leverage Asset}}{\text{Asset– to– Sales} - [\text{Net Margin X Retention x Leverage}]}$$

$$\frac{P \times S_0 \times b(1+\frac{D}{E})}{A - P \times S_0 \times b \times (1+\frac{D}{E})}$$

Where, P = Net Profit Margin on Sales
S = Sales for the Year Ended
g = Growth in Sales = Growth in Assets
A = Total Net Assets at the end of the Period [Capital Employed]
D/E = Debt-Equity Ratio
b = Retention Ratio

Q30. Write short notes on Economic Value Added Method.

1. **Meaning:** Economic Value Added (EVA) is the surplus generated by an entity after meeting an equitable charge towards the providers of Capital. It is the returns earned in excess of the funds required to rr.r: cost of capital.
2. **Mathematical Notation:**

   Economic Value Added (EVA) = Operating Profit
   Less Taxes
   Less Capital Employed × Weighted Average Cost of Capital
3. **Increasing EVA:** EVA can be increased by —
   (a) Improving the operating profits by efficient operation, without employing additional capital.
   (b) Investing in new projects which give higher returns than the cost of their financing.
   (c) Liquidating unproductive capital i.e. buy-back of shares, redemption of debentures, etc.

Q31. Explain the Shareholder Value Analysis.

1. Meaning:
   (a) **Meaning:** Shareholder Value Analysis (SVA) focuses on the creation of economic value for Shareholders, as measured by share price performance and flow of funds.
   (b) Shareholder Value is used to link management strategy and decision to the creating of value for shareholders.
2. **Value Drivers:** Factors or Value Drivers which influences the Shareholder's Value are identified. **Example:** Growth in Sales, Profit Margin, Capital Investment Decisions, etc.
3. **Management Responsibilities:** Management should pay attention to Value Drivers, while taking investment and finance decisions.

4. Benefit:
   (a) SVA helps the management to concentrate on activities which create value to the Shareholders rather than on short-term profitability.
   (b) SVA and EVA together helps to strengthen the competitive position of the Firm, by focusing on wealth creation.

(c) They provide an objective and consistent framework of evaluation and decision-making across all functions, departments and units of the Company.

Q32. What are the commonly used bases to compute the Exchange Ratio?

Aspect	Earnings Per share (EPS)	Market Price per Share (MPS)	Book Value per share (BVS)
Computation	$\frac{\text{EPS of Selling Co.}}{\text{EPS of Buying Co.}}$	$\frac{\text{MPS of Selling Co.}}{\text{MPS of Buying Co.}}$	$\frac{\text{BVS of Selling Co.}}{\text{BVS of Buying Co.}}$
Suitability	When there are **no differential risks** associated with the two companies entering into Merger.	When the Shares of the acquiring and the target Firm **are actively traded** in the market.	If **accounting policies are to be reflected** in the determination of Exchange Ratio.
Demerits	1. Difference in growth rate of earnings of two Companies will not be highlighted. 2. Gains in earnings arising out of merger is not considered to determine Exchange Ratio.	• When the trading is thin, market prices may not be a reliable measure. • Market prices may be manipulated by vested interest and the Exchange Ratio determined may not reflect the true position.	Exchange Ratio determined under this method does not reflect the purchasing power of money, and are highly different from true economic values.

Wishing You All The Best
Remember You Can Do Wonders , Nobody Can Stop You From Achieving Success Except You
Get Up and Keep Going, World Is Waiting For You
— Rasesh Tandon
Believe me it''ll work. So be ready to face such situations

Best of Luck