MODULE VII – VALUATION APPLICATION – ANALYSIS OF BUSINESS ENVIRONMENT

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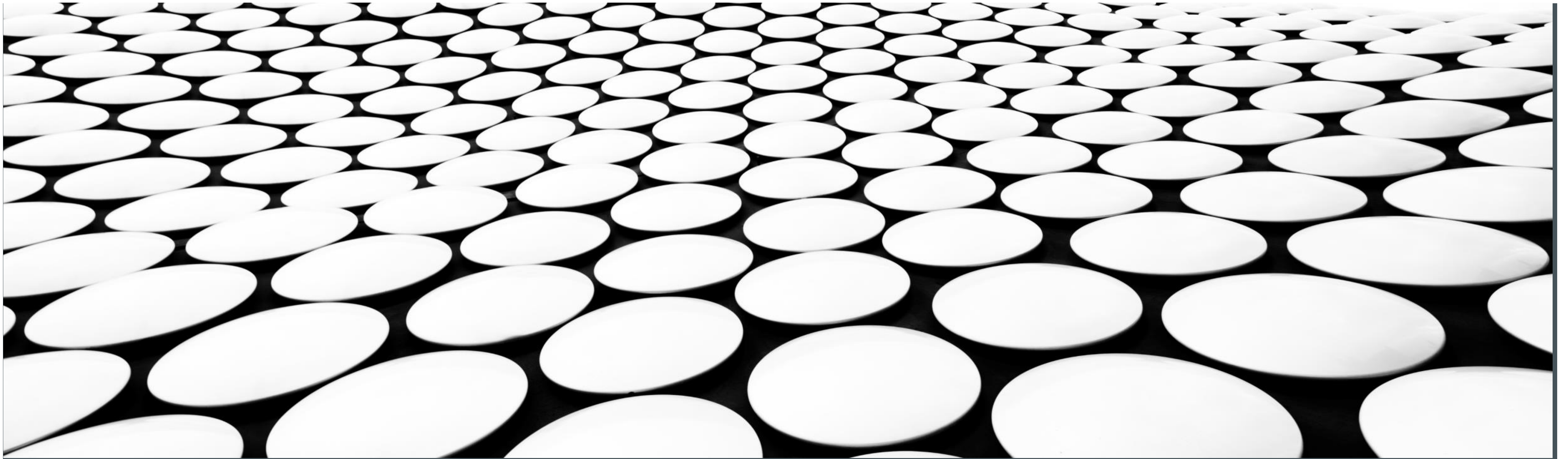


ANALYSIS OF BUSINESS ENVIRONMENT

ANALYSIS OF BUSINESS ENVIRONMENT

- An Organization's strategy gives an idea about what the organization wants to achieve and the process how they want to achieve it.
- It basically includes the purpose of the entire organization, its goals, and objectives as well as the plans and methods that they are considering so that they can achieve this.

> "**Business strategy** is less a function of grandiose predictions than it is a result of being able to respond rapidly to real changes as they occur. That's why strategy has to be dynamic and anticipatory." - **Jack Welch.**

- A business strategy is a report that shows the plans of the entire business.
- It is a plan that is often used so that they can attract financing from big investors as well as creditors.
- This is a plan designed to give information regarding a new venture so that they can convince financial backers to invest in the said business

TYPES OF STRATEGY

- **Strategy in general.** This refers to how a specific objective will be achieved. The strategy in general mainly concerns the relationship between the results we want to have and the resources that are currently at our disposal.

- **Corporate strategy.** This defines the market and the business segment wherein a certain company will operate. Corporate strategy is usually decided through the context of being able to define the company's mission and vision. This is the same as being able to recognize what the company does, why it exists in the first place and what it intends to become in the future.

- **Competitive strategy.** This describes competitive ability of a given business and a strategy around it. This type of strategy is centred on the company's capabilities, its strengths, and weaknesses. This is used in relation to the market characteristics as well as the corresponding abilities, strong points, and weaknesses of the competitors.

CREATING A STRATEGY

The creation of strategy usually involves several steps:

- ❑ Set a Vision and a Mission Statement
- ❑ Five forces Analysis
- ❑ SWOT analysis - Strengths, Weaknesses, Opportunities and Threats
- ❑ PEST Analysis
- ❑ GE/McKinsey Matrix
- ❑ ADL Matrix
- ❑ Highlighting Core competencies
- ❑ Setting Goals / Objectives
- ❑ Setting Key Performance Indicators or KPIs

VISION STATEMENT

- A vision statement is a strategic intent of an organization.
- It is an overarching set of aspirations which the organization hopes to achieve or become.
- These are the inspiring words chosen by successful leaders to clearly and concisely convey the direction of the organization

FIVE FORCES ANALYSIS

- ❑ Michael Porter's Five Forces tool is a simple but powerful tool for understanding where power lies in a business situation. This is useful, because it helps the organization to understand both the strength of its current competitive position, and the potential strength of a position where it aspires moving into.
- ❑ Five Forces Analysis assumes that there are five important forces that determine competitive power in a business situation. These are:
- ➢ **Supplier Power:** Here we evaluate how easy it is for suppliers to drive up prices. This is driven by the number of suppliers of each key input, the uniqueness of their product or service, their strength and control over our business, the cost of switching from one to another, and so on.
- ➢ **Buyer Power:** Here we ask ourselves how easy it is for buyers to drive prices down. Again, this is driven by the number of buyers, the importance of each individual buyer to the business, the cost to them of switching from the entity’s products and services to those of someone else, and so on
- ➢ **Competitive Rivalry:** What is important here is the number and capability of the competitors of the organization.
- ➢ **Threat of Substitution:** This is affected by the ability of the organization’s customers to find a different way of doing what it does.
- ➢ **Threat of New Entry:** Power is also affected by the ability of people to enter the market reach of the organization.

SWOT ANALYSIS

- SWOT Analysis is a very effective technique for understanding Strengths and Weaknesses of the organization, and for identifying both the Opportunities open to it and the Threats it faces.

- Used in a business context, a SWOT Analysis helps the organization to carve a sustainable niche in the market it operates.

- Originated by Albert S Humphrey in the 1960s, SWOT Analysis is as useful today as it was then. This can be applied it in two ways –
  a) as a simple icebreaker helping people get together to "kick off" strategy formulation, or
  b) in a more sophisticated way as a serious strategy tool.

PEST ANALYSIS

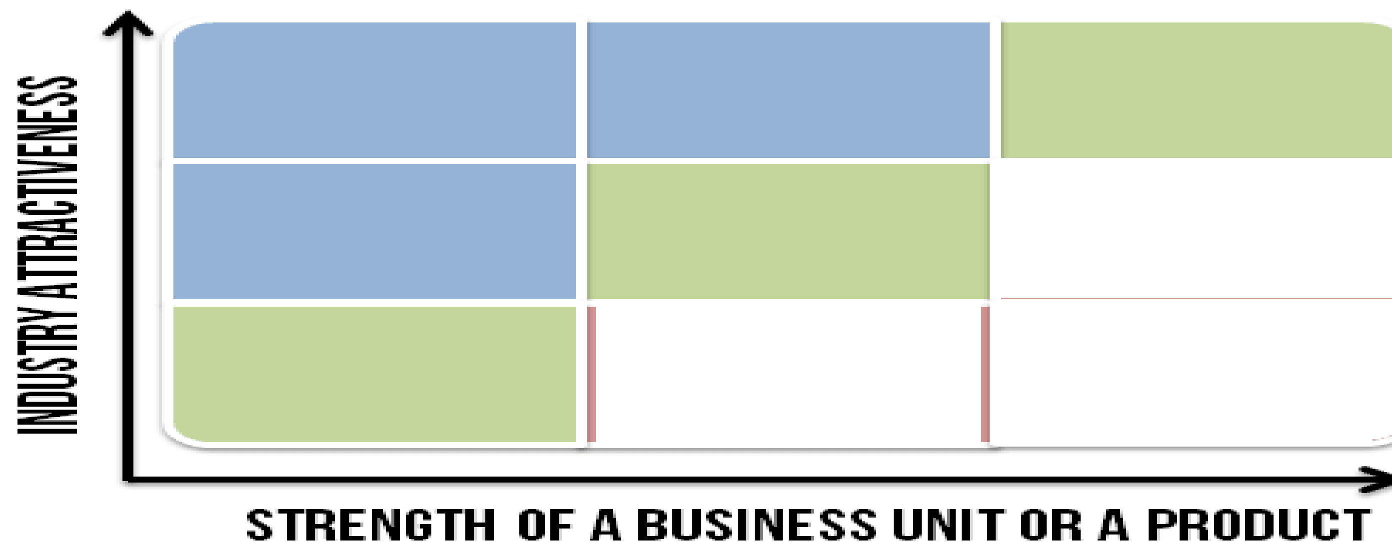
- PEST Analysis is a simple but important and widely used tool that helps to understand the big picture of the **P**olitical, **E**conomic, **S**ocio-Cultural, and **T**echnological environment the organization is operating in. PEST is used by business leaders worldwide to build their vision of the future.

- It is important for these reasons:

- By making effective use of PEST Analysis, the organization ensures that it is aligned positively with the forces of change that are affecting our world. By taking positive steps to usher in the change, it has more likelihood to be successful.
- Positive use of PEST Analysis helps the organization to avoid taking action that is destined towards failure for reasons beyond its control.
- PEST is useful when the organization starts operating in a new country or region. Use of PEST Analysis assists the organization to break free of theoretical assumptions, and helps the organization to quickly adapt to the realities of the new environment.

GE / MCKINSEY MATRIX

- In 1970s, General Electric was managing a huge and complex portfolio of unrelated products and was unsatisfied about the returns from its investments in the products.
- At the time, companies usually relied on projections of future cash flows, future market growth or some other future projections to make investment decisions, which was an unreliable method to allocate the resources.
- Therefore, GE consulted the McKinsey & Company and as a result the nine-box framework was designed.
- The nine-box matrix plots the Business Units on its 9 cells that indicate whether the company should invest in a product, harvest/divest it or do a further research on the product and invest in it if there are still some resources left. The BUs are evaluated on two axes: industry attractiveness and a competitive strength of a unit.



ADL MATRIX

- This is a Portfolio Management technique and is based on the Product Life Cycle. It has been developed in the 1980's by Arthur D. Little, Inc. (ADL), one of the best-known consulting firms, intended to help companies to manage their basket of product businesses as a portfolio.

- Like other portfolio planning matrices, the **ADL matrix** represents a company's various businesses in a two-dimensional matrix.

- It is a structured methodology for consideration of strategies which are dependent on the life cycle of the industry.

- The ADL approach uses the dimensions of environment assessment and business – strength assessment i.e. Competitive Position and Industry Maturity.

CORE COMPETENCIES

- Core competency is a unique skill or technology that creates distinct customer value.
- In their key 1990 paper "The core competence of the Corporation" C.K.Prahalad and Gary Hamel argue that "Core Competences" are some of the most important sources of uniqueness:
- These are the things that a company can do uniquely well, and that no one else can copy quickly enough to affect competition.
- Hamel and Prahalad provided three tests to see whether these are true core competences:

Tests	Description
Relevance	**Firstly, the competence must give your customer something that strongly influences him or her to choose your product or service. If it does not, then it has no effect on your competitive position and is not a core competence.**
Difficulty of imitation	**Secondly, the core competence should be difficult to imitate. This allows you to provide products that are better than those of your competition. And because you are continually working to improve these skills, means that you can sustain its competitive position.**
Breadth of application	**Thirdly, it should be something that opens up a good number of potential markets. If it only opens up a few small, niche markets, then success in these markets will not be enough to sustain significant growth.**

SETTING GOALS / OBJECTIVES

Goal setting should cover the following attributes:

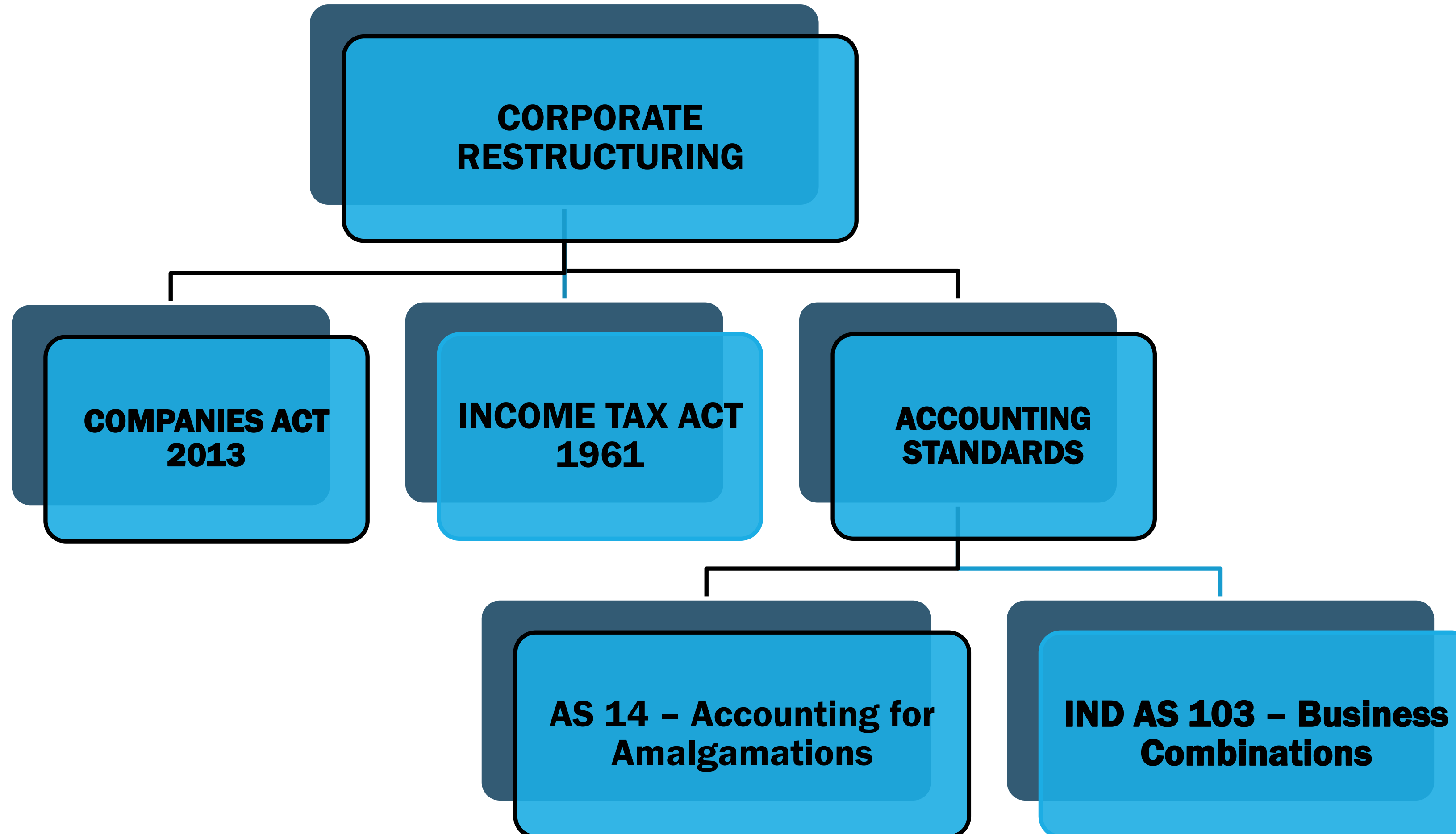
- ❑ **Specific:** Goal objectives should address the five Ws… who, what, when, where, and why. Make sure the goal specifies what needs to be done with a timeframe for completion.
- ❑ **Measurable:** Goal objectives should include numeric or descriptive measures that define quantity, quality, cost, etc.
- ❑ **Achievable:** Goal objectives should be within the staff member's control and influence; a goal may be a "stretch" but still feasible.
- ❑ **Relevant:** Goals should be instrumental to the mission of the department (and ultimately, the institution).
- ❑ **Time-bound:** Goal objectives should identify a definite target date for completion and/or frequencies for specific action steps that are important for achieving the goal.

SETTING KEY PERFORMANCE INDICATORS

- Key Performance Indicators, also known as KPI or Key Success Indicators (KSI), help an organization define and measure progress toward organizational goals.
- Key Performance Indicators are quantifiable measurements, agreed to beforehand, that reflect the critical success factors of an organization. They will differ depending on the organization.
- Whatever Key Performance Indicators are selected, they must reflect the organization's goals, they must be key to its success, and they must be quantifiable (measurable).
- Key Performance Indicators usually are long-term considerations.

COPORATE RESTRUCTURING
ON EQUITY / BUSINESS VALUATION

COPORATE RESTRUCTURING



COPORATE RESTRUCTURING

Forces that drive Corporate Restructuring

- Rapid pace of technological change.
- Low costs of communication and transportation.
- Globalization and global markets.
- Nature of competition in terms of forms, sources, and intensity.
- Emergence of new types of industries.
- Regulation in some industries and sectors.
- Liberalization in some industries and sectors.
- Growing inequalities in incomes and wealth.

COPORATE RESTRUCTURING

Forms of Corporate Restructuring

Expansion
Amalgamation This involves fusion of one or more companies where the companies lose their individual identity and a new company comes into existence to take over the business of companies being liquidated.
Absorption This involves fusion of a small company with a large company where the smaller company ceases to exist after the merger.
Tender offer This involves making a public offer for acquiring the shares of a target company with a view to acquire management control in that company
Asset acquisition This involves buying assets of another company. The assets may be tangible assets like manufacturing units or intangible like brands
Joint venture This involves two companies coming whose ownership is changed

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Forms of Corporate Restructuring

Contraction
Demerger-spin off This type of demerger involves division of company into wholly owned subsidiary of parent company by distribution of all its shares of subsidiary company on Pro-rata basis. By this way, both the companies i.e. holding as well as subsidiary company exist and carry on business.
Demerger - Equity carve out This is similar to spin offs, except that same part of shareholding of this subsidiary company is offered to public through a public issue and the parent company continues to enjoy control over the subsidiary company by holding controlling interest in it.
Demerger – Split-up This type of demerger involves the division of parent company into two or more separate companies where parent company ceases to exist after the demerger.
Asset sale This involves sale of tangible or intangible assets of a company to generate cash. A partial sell off, also called slump sale, involves the sale of a business unit or plant of one firm to another. It is the mirror image of a purchase of a business unit or plant. From the seller's perspective, it is a form of contraction and from the buyer's point of view it is a form of expansion
Divestiture These are sale of segment of a company for cash or for securities to an outside party. Divestitures, involve contraction.

COPORATE RESTRUCTURING

Forms of Corporate Restructuring

Corporate control
Going private This involves converting a listed company into a private company by buying back all the outstanding shares from the markets
Equity buy back This involves the company buying its own shares back from the market. This results in reduction in the equity capital of the company. This strengthens the promoter's position by increasing his stake in the equity of the company
Leveraged buy-outs This involves raising of capital from the market or institutions by the management to acquire a company on the strength of its assets.
Anti – takeover defences With the incidence of high value of hostile takeover activity in recent years, takeover defences both premature and reactive have been restored by the companies.

COPORATE RESTRUCTURING

Important Legislations related to Corporate Restructuring

- ❑ **Companies Act, 2013.**
- ❑ **Income Tax Act, 1961.**
- ❑ **Accounting Standards.**

COPORATE RESTRUCTURING

Companies Act 2013

Provisions under Companies Act, 2013	Description
Sec 230	Provides for power to Tribunal to make order on the application of the company or any creditor or member or in the case of company being wound up, of liquidator for the proposed compromise or make arrangements with creditors and members.
Sec 231	Provides for power of NCLT to supervise the implementation of the compromise or arrangement and enforce the same. The section also provides that if the Tribunal is satisfied that such compromise or arrangement cannot be implemented satisfactorily with or without modifications, and the company is unable to pay its debts as per the scheme, it may make an order for winding up of the company
Sec 232	Provide powers to NCLT to order for holding meeting of the creditors or the members and to make orders on the proposed reconstruction, merger, or amalgamation of companies.
Sec 233	Seeks to provide for merger or amalgamation between two small companies or between a holding company and its wholly owned subsidiary company by giving notice of the proposed scheme inviting objections or suggestions by both the transferor and the transferee company from Registrar, Official liquidator or persons affected by the scheme. The scheme is to be approved by the respective members at a general meeting holding ninety per cent of total number of shares and also by nine tenth in value of creditors of respective companies. Both the transferor and transferee company has to file declaration of solvency. Transferee company shall file a copy of the approved scheme with the Central Government. On registration of the scheme, the transferor company shall be deemed to be dissolved. The Central Government may make rules for merger and amalgamation of companies.

COPORATE RESTRUCTURING

Companies Act 2013

Provisions under Companies Act, 2013	Description
Sec 234	Provides for Merger & Amalgamation of companies registered under the Act of 2013 with foreign company. The Central Government may in consultation with Reserve Bank of India make rules for the purpose of merger or amalgamation provided under this section.
Sec 235	Provides the manner in which the transferee company shall acquire shares of the shareholders dissenting from the scheme or contract as approved by the majority shareholders holding not less than nine-tenths in value of the shares whose transfer is involved.
Sec 236	Provides for the procedure and manner in which the registered holder of at least 90 percent shares of a company shall notify the company of their intention to purchase remaining equity share of minority shareholders by virtue of an amalgamation, share exchange, conversion of securities etc, provision for valuation of shares having been provided by a registered valuer. This section provides for the procedure to be followed for acquisition of shares held by minority shareholders.

COPORATE RESTRUCTURING

Companies Act 2013

Provisions under Companies Act, 2013	Description
Sec 237	Provides for power of Central Government to provide for amalgamation of Companies in public interest by passing an order to be notified in the Official Gazette.
Sec 238	This section seeks to provide for registration of offer of schemes or contract involving transfer of shares.
Sec 239	Specifies provisions related to preservation of books and papers of amalgamated companies
Sec 240	This section seeks to provide for liability of officers in respect of offences committed prior to merger, amalgamation etc.

COPORATE RESTRUCTURING

Income Tax Act 1961

Merger

Merger has been defined as amalgamation under Sec 2(1B) and it means that the merger of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a result of the merger, as the amalgamated company) in such a manner that:

(i) all the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of the amalgamation.

(*ii*)all the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of the amalgamation.

(*iii*)shareholders holding not less than three-fourths in value of the shares in the amalgamating company or companies (other than shares already held therein immediately before the amalgamation by, or by a nominee for, the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a result of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of the distribution of such property to the other company after the winding up of the first-mentioned company.

It may be noted that while evaluating the tax implications of restructuring, it is imperative to know the definition of the term ‘Amalgamation’ as per Income Tax.

COPORATE RESTRUCTURING

Income Tax Act 1961

Demerger

In accordance with section 2(19AA) of the Income Tax Act, 1961, unless the term “demerger”, in relation to companies, means the transfer, pursuant to a scheme of arrangement the Companies Act, 2013, by a demerged company of its one or more undertakings to any resulting company in such a manner that-

(*i*) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

(*ii*)all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger.

(*iii*)the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger.

However according to proviso inserted vide Finance Act 2019, applicable effective 1 April 2020, the provisions of this sub-clause shall not apply where the resulting company records the value of the property and the liabilities of the undertaking or undertakings at a value different from the value appearing in the books of account of the demerged company, immediately before the demerger, in compliance to the Indian Accounting Standards specified in Annexure to the Companies (Indian Accounting Standards) Rules, 2015.

COPORATE RESTRUCTURING

Income Tax Act 1961

Demerger

(*iv*)the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a proportionate basis except where the resulting company itself is a shareholder of the demerged company.

(*v*) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(*vi*)the transfer of the undertaking is on a going concern basis.

(vii)the demerger is in accordance with the conditions, if any, notified under sub-section (5) of section 72A by the Central Government in this behalf.

Resulting company, according to section 2(41A) of Income Tax Act,1961 means one or more company, (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger, and the resulting company in consideration of such transfer of undertaking issues shares to the shareholders of the demerged company and include any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger.

COPORATE RESTRUCTURING

Accounting Standards – A comparative analysis

S/L No	Ind AS 103 Business Combinations	AS 14 Accounting for Amalgamations (as amended)
1	Prescribes only the acquisition method for each business combination.	Prescribes two methods: – Pooling of interest method – Purchases method
2.	**Purchase method – values on acquisition** Assets, liabilities, and contingent liabilities of acquired entity are fair valued. If control is obtained in a partial acquisition of a subsidiary the full value of the assets, liabilities and contingent liabilities including portion attributable to the minority (non-controlling) interest is recorded in consolidated business. Goodwill is recognised as the residual between the consideration paid and the percentage of the business acquired. Liabilities for restructuring activities are recognised only when acquiree has an existing liability at acquisition date. Liabilities for future losses or other costs expected to be incurred as a result of the business combination cannot be recognised.	For an entity acquired and held as a subsidiary, the assets acquired, and liabilities assumed are incorporated in their existing carrying amounts for consolidation purposes. On amalgamation they may be incorporated at their existing carrying amounts or alternatively the consideration is allocated to individual identifiable assets and liabilities at their fair values. On business acquisition they may be incorporated at their fair values or values of surrendered assets. No separate restructuring provision is recognised on acquisition.

COPORATE RESTRUCTURING

Accounting Standards – A comparative analysis

S/L No	Ind AS 103 Business Combinations	AS 14 Accounting for Amalgamations (as amended)
3.	**Non-controlling interest** Stated at minority's share of the fair value of acquired identified assets liabilities and contingent liabilities	**Stated at minority's share of pre-acquisition carrying value of net assets**
4.	**Purchase method – goodwill and intangible assets with indefinite useful lives** Capitalized but not amortized. Goodwill and indefinite intangible assets are reviewed for impairment at least annually at either the Cash Generating Unit (CGU) levels or groups of CGUs as applicable.	Goodwill on consolidation and business acquisitions; no specific guidance – practice varies, between no amortization versus amortization over a period not exceeding 10 years. Goodwill on amalgamation is amortized over a period not exceeding 5 years unless a longer period is justified. Goodwill is reviewed for impairment whenever an indication of impairment exists at CGU level. Intangible assets are not classified into indefinite useful lives category. All intangible assets are amortized over a period not exceeding 10 years.
5.	**Purchase method – capital reserve** The identification and measurement of acquiree's identifiable assets, liabilities and contingent liabilities are reassessed. Any excess remaining after reassessment is recognised in capital reserve in the form of Bargain Purchase.	Negative goodwill is recorded in equity as capital reserve, which is not amortized to income. However, in case of amalgamation, the fair value of intangible assets with no active market is reduced to the extent of capital reserve, if any, arising on the amalgamation.

COPORATE RESTRUCTURING

Accounting Standards – A comparative analysis

S/L No	Ind AS 103 Business Combinations	AS 14 Accounting for Amalgamations (as amended)
6.	**Pooling of interest method Prohibited.** However, as per Appendix C of Ind AS 103, Business combinations involving entities or businesses under common control shall be accounted for using the pooling of interests method. According to this Appendix, pooling of interest method would involve: (i) The assets and liabilities of the combining entities are reflected at their carrying amounts. (ii) No adjustments are made to reflect fair values, or recognise any new assets or liabilities. The only adjustments that are made are to harmonize accounting policies. (iii) The financial information in the financial statements in respect of prior periods should be restated as if the business combination had occurred from the beginning of the preceding period in the financial statements, irrespective of the actual date of the combination. However, if business combination had occurred after that date, the prior period information shall be restated only from that date.	**Pooling of interest method** Required for certain types of amalgamation when all the conditions are met.

COPORATE RESTRUCTURING

Computation of valuation of Goodwill

Particulars	Amount
(a) Aggregate of (i) the consideration transferred measured in accordance with this Ind AS, which generally requires acquisition date fair value (ii) the amount of non-controlling interest in the acquiree measured in accordance with this Ind AS and (iii) in case of business combination achieved in stages (Ind AS103, para 41 and 42), the acquisition date fair value of the acquirer's previously held equity interest in the acquiree	X X X
TOTAL (A)	X
(b) The net of acquisition date amounts of the identifiable assets acquired, and the liabilities assumed measured in terms of this Ind AS	X
TOTAL (B)	X
Goodwill (A- B)	X
Bargain purchase (B – A)	X *

* Bargain purchase will be recognized as capital reserve under Ind AS

COPORATE RESTRUCTURING – COMPARATIVE SUMMARY

AS	IFRS	US GAAP	Ind AS
Business combinations No particular standard has been issued by ICAI till date. However all business acquisitions are business combinations except pooling of interest method for certain amalgamations	All business combinations are combinations as per IFRS 3 Business combinations	Same as IFRS	All business combinations are combinations as per Ind AS 103 Business combinations
Purchase method – values on acquisition For an entity acquired and held as a subsidiary, the assets acquired and liabilities assumed are incorporated in their existing carrying amounts for consolidation purposes. On amalgamation they may be incorporated at their existing carrying amounts or alternatively the consideration is allocated to individual identifiable assets and liabilities at their fair values. On business acquisition they may be incorporated at their fair values or values of surrendered assets. No separate restructuring provision is recognised on acquisition.	Assets, liabilities and contingent liabilities of acquired entity are fair valued. If control is obtained in a partial acquisition of a subsidiary the full value of the assets, liabilities and contingent liabilities including portion attributable to the minority (non-controlling) interest is recorded in consolidated business. Goodwill is recognised as the residual between the consideration paid and the percentage of the business acquired. Liabilities for restructuring activities are recognised only when acquiree has an existing liability at acquisition date. Liabilities for future losses or other costs expected to be incurred as a result of the business combination cannot be recognised.	Similar to IFRS except that minority interest is stated at pre-acquisition carrying value of net assets and contingent liabilities of the acquiree are not recognised at the date of acquisition. Specific rules exist for acquired in process research and development (generally expensed) and contingent liabilities. Some restructuring liabilities relating solely to the acquired entity may be recognised if specific criteria about restructuring plans are met.	Assets, liabilities and contingent liabilities of acquired entity are fair valued. If control is obtained in a partial acquisition of a subsidiary the full value of the assets, liabilities and contingent liabilities including portion attributable to the minority (non-controlling) interest is recorded in consolidated business. Goodwill is recognised as the residual between the consideration paid and the percentage of the business acquired. Liabilities for restructuring activities are recognised only when acquiree has an existing liability at acquisition date. Liabilities for future losses or other costs expected to be incurred as a result of the business combination cannot be recognised.

COPORATE RESTRUCTURING – COMPARATIVE SUMMARY

AS	IFRS	US GAAP	Ind AS
Non-controlling (minority)interest Stated at minority's share of pre-acquisition carrying value of net assets	Stated at minority's share of the fair value of acquired identified assets liabilities and contingent liabilities	Similar to Indian Accounting Standards	Stated at minority's share of the fair value of acquired identified assets liabilities and contingent liabilities
Purchase method – goodwill and intangible assets with indefinite useful lives Goodwill on consolidation and business acquisitions; no specific guidance – practice varies, between no amortisation versus amortisation over a period not exceeding 10 years. Goodwill on amalgamation is amortised over a period not exceeding 5 years unless a longer period is justified. Goodwill is reviewed for impairment whenever an indication of impairment exists at CGU level. Intangible assets are not classified into indefinite useful lives category. All intangible assets are amortised over a period not exceeding 10 years.	Capitalised but not amortised. Goodwill and indefinite intangible assets are reviewed for impairment at least annually at either the Cash Generating Unit (CGU) levels or groups of CGUs as applicable.	Similar to IFRS although the level of impairment testing and the impairment test itself are different	Capitalised but not amortised. Goodwill and indefinite intangible assets are reviewed for impairment at least annually at either the Cash Generating Unit (CGU) levels or groups of CGUs as applicable.

COPORATE RESTRUCTURING – COMPARATIVE SUMMARY

AS	IFRS	US GAAP	Ind AS
Purchase method – capital reserve Negative goodwill is recorded in equity as capital reserve, which is not amortised to income. However, in case of amalgamation, the fair value of intangible assets with no active market is reduced to the extent of capital reserve, if any, arising on the amalgamation.	The identification and measurement of acquiree's identifiable assets, liabilities and contingent liabilities are reassessed. Any excess remaining after reassessment is recognised in income statement immediately in the form of Bargain Purchase	Any remaining excess after reassessment is used to reduce proportionately the fair values assigned to non-current assets (with certain exceptions) Any excess is recognised in the income statement immediately as an extraordinary gain.	The identification and measurement of acquiree's identifiable assets, liabilities and contingent liabilities are reassessed. Any excess remaining after reassessment is recognised in capital reserve in the form of Bargain Purchase.
Pooling of interest method Required for certain types of amalgamation when all the conditions are met.	Prohibited	Prohibited	-

DUE DILIGENCE – ITS IMPACT ON
EQUITY AND BUSINESS VALUATION

WHAT IS DUE DILIGENCE

- ❑ Due Diligence is the art and science of comprehensive evaluation of the financial health and hygiene of an organization and it is normally performed when a buyer wants to acquire an organization.
- ❑ It includes a complete investigation of the following related to the target entity:
- financial management system including the process of maintaining accounting records, compilation and reporting of financial numbers related to the capital structure, investments, assets and liabilities, revenue, and expense reporting of the organization,
- the pillars of the control environment and internal control process on which the edifice of financial management system rests,
- Risk management arising out of the business drivers which drive the historic and projected order book, sales revenue, cost structure, profitability, and projected cash flow analysis.

OBJECTIVES OF DUE DILIGENCE

- Develop an in-depth understanding of the financial statements of the target entity,
- Unearth, the hidden liabilities that may be lurking behind the audited financial statements,
- Identify potential impairment losses that may arise in the tangible, intangible and financial assets of the target entity owing to the impact of the business environment, in which the target entity operates,
- External factors like the onset of COVID-19 pandemic on the future business of the target entity and its impact on the financial health including future cash flows of the target entity,
- Evaluate and identify possible weaknesses in the control environment of the organization which may trigger significant risks to the prospective financial situation of the target company,
- Come up with a credible valuation of the target entity based on the quality of the financial statements including future cash flows of the organization.
- Identify potential deal breakers related to the target entity which need to be flagged early enough for negotiation by both entities.

FUNDAMENTAL PRINCIPLES OF DUE DILIGENCE

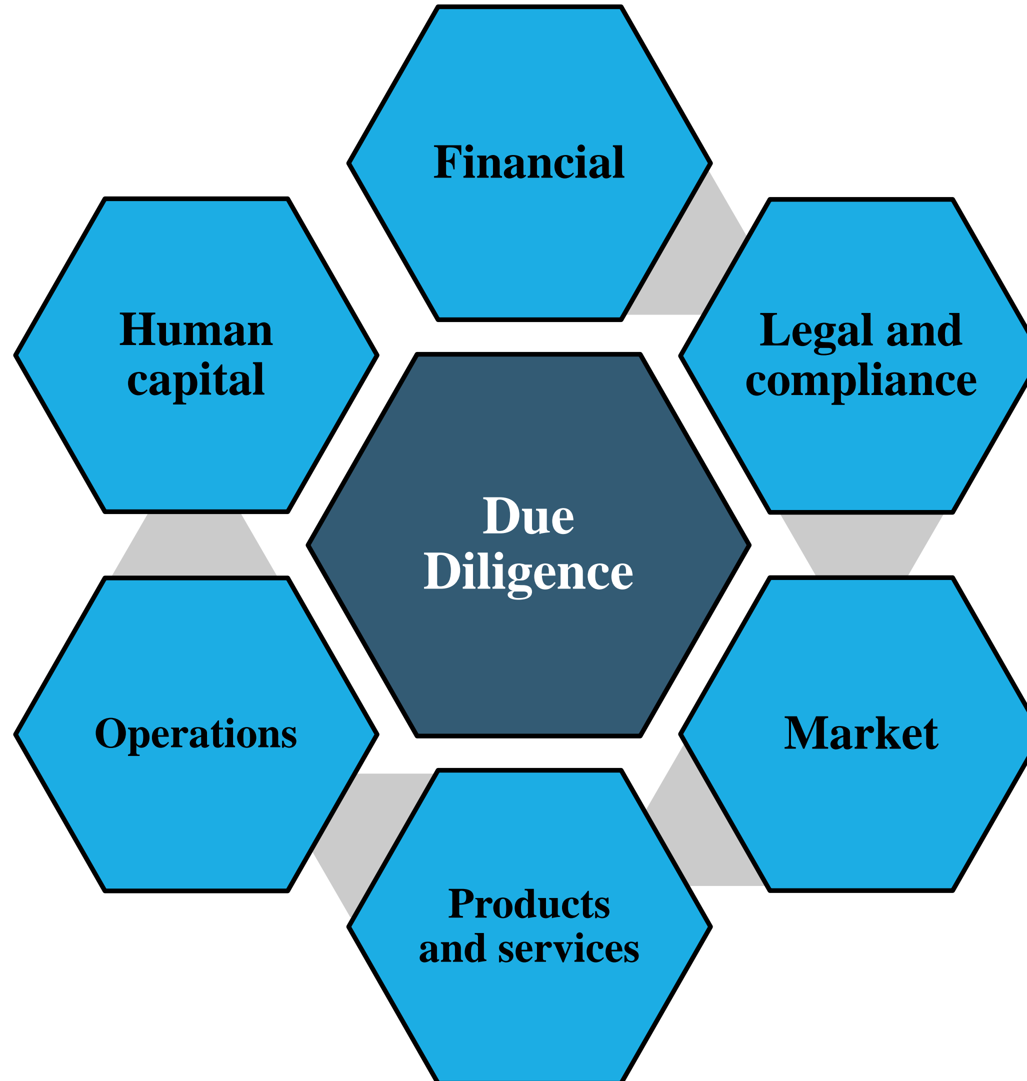
- Independence
- Prudence
- Completeness
- Materiality
- Substance over legal form

METHODS OF DUE DILIGENCE

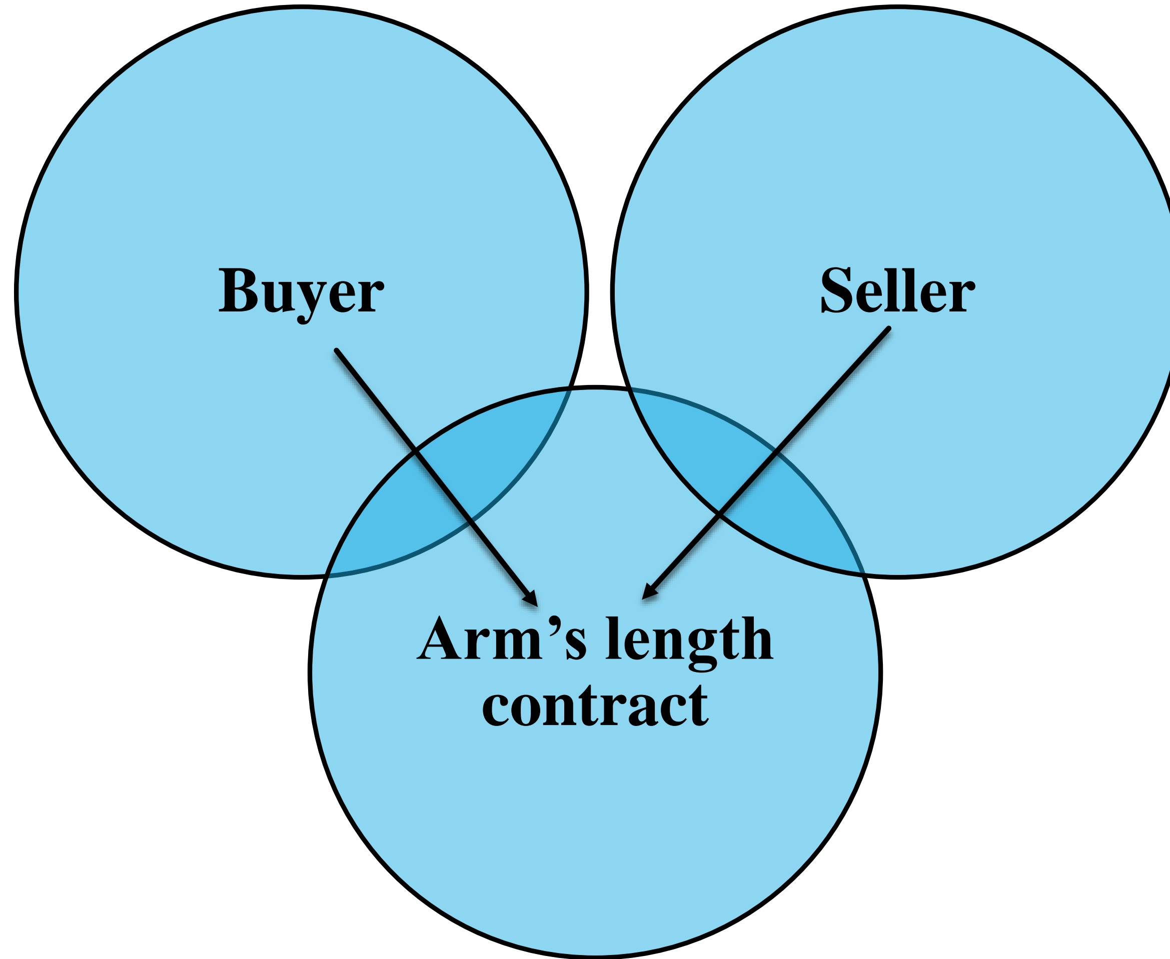
The conventional methods of performing Financial Due Diligence would be:

- Analysis of the Financial Statements of the target organization,
- Analysis of the control environment and risk mitigation process within the organization,
- Interview of the stake holders including key employees of the organization,
- Analysis of the external business environment under which the target entity operates,
- Study of the business model of the target organization, the market within which it operates, the competition, and potential roadblocks that may arise in the future, that may adversely impact the future cash flows of the organization.

KEY AREAS COVERED IN DUE DILIGENCE



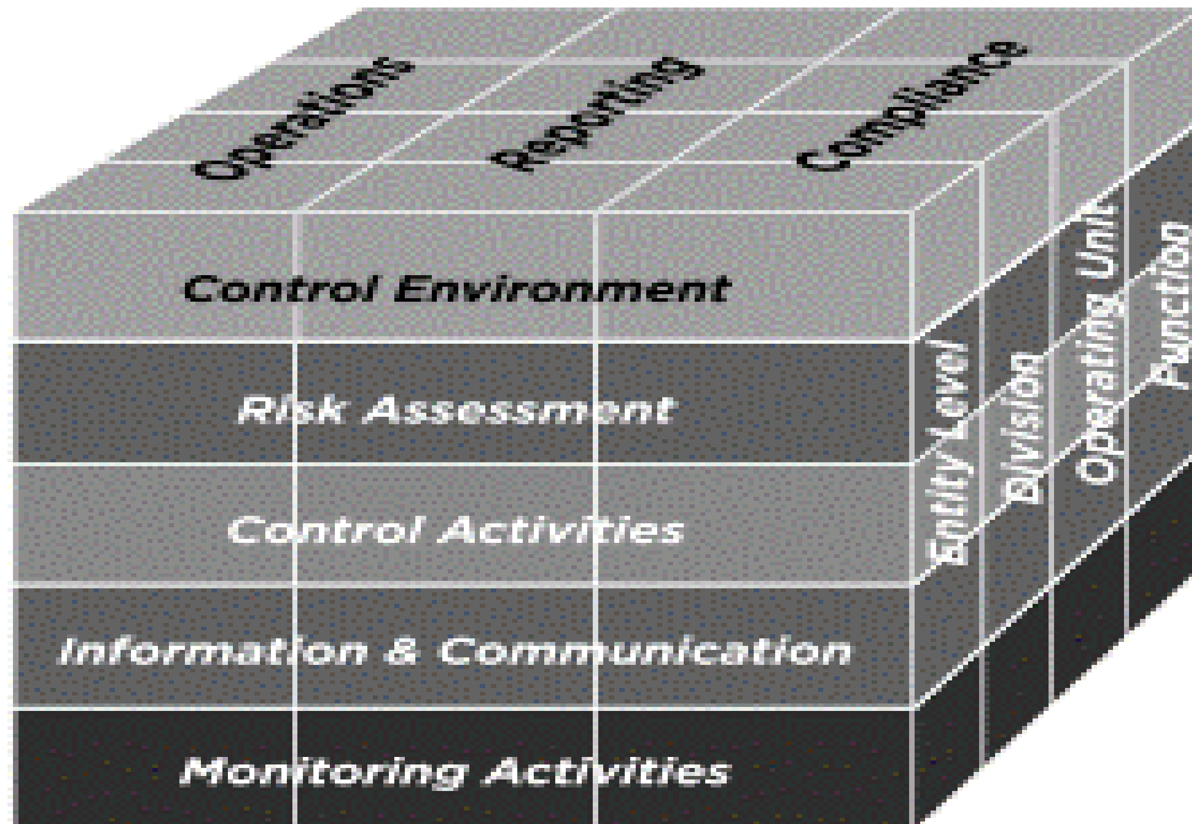
TWO SIDES OF DUE DILIGENCE



ENTERPRISE RISK MANAGEMENT AND
EQUITY AND BUSINESS VALUATION

ENTERPRISE RISK MANAGEMENT – AN OVERVIEW

ERM is a process-based approach where the various components interact as part of an on-going, iterative process. COSO represents these relationships in a three-dimensional cube as shown below:



CONTROL ENVIRONMENT

It creates a set of standards, processes, and structures that provide the basis for carrying out internal control.

The Control Environment should ensure controls are in place, covering areas such as:

- Clear lines of responsibility and authority
- Procurement policy
- Three-way match in vendor payments
- Code of Ethics
- Whistle-blower policies
- Hiring practices
- Training programs

RISK ASSESSMENT

Risk Assessment factors	Risks
1. Materiality of the amounts	• Large value/transaction • High volume of transactions • Significant impact on key ratios or disclosures
2. Complexity of the process	• Limited internal skills • Multiple data handoffs • Highly technical in nature
3. History of accounting adjustments	• Accounting errors • Valuation adjustments, etc.
4. Propensity for change in	• Business processes or controls • Related accounting

CONTROL ACTIVITIES

INFORMATION AND COMMUNICATION

- Accurate, timely information is necessary to properly carry out internal control responsibilities in support of the achievement of an organization's objectives.

- Communication is the continual, iterative process of providing, sharing, and obtaining that necessary information.

MONITORING ACTIVITIES

Monitoring activities are evaluations used to ascertain whether components of internal control are *present* and *functioning*. These evaluations can be split into two categories:

- **Ongoing** evaluations are built into business processes and provide timely information on the underlying controls.

- **Separate** evaluations are conducted periodically and vary in scope and frequency based on prior assessments of risk, the effectiveness of *ongoing* evaluations, and other management considerations such as resource prioritization. Separate evaluations include Internal Audit activities.

THANK YOU!