

# Example of estridge executive memorandum case study

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All businesses are evaluated based on their performance. In the previous years, incomes or profits were used to estimate their performance. The Generally Accepted Accounting Principles (GAAP) and the International Accounting Standards (IAS) define profits as cash and non-cash net revenues regardless of whether they have been paid for, or not. This presents a drawback because some non-cash incomes like gain on disposal of assets and decrease in the provision for doubtful and bad receivables are not realistic. In an attempt to solve this, application of cash flows to evaluate the performance of a business emerged.

Cash flow method has been advanced to Discounted Cash Flow model, which equates future earnings to present day value through the concept of the time value of money. Most investors prefer this technique to earnings arguing that it is less exposed to manipulation, easily measured, and intuitive. Cash flows can be classified into relevant, irrelevant, and free cash flows. According to GAAP, relevant cash flows are defined as incremental cash flows after tax expected from a future investment or acquisition that has been proposed. Irrelevant cash flows are those expenses incurred at a fixed rate regardless of the business performance. Lastly, free cash flows are profits from the operations of a business. It is crucial to distinguish these three types since business valuation relies on relevant cash flows only.

In summary, in spite of the significant stronghold of the discounted cash flow method, (establishing the current value of future earnings) it suffers from several pitfalls, for instance, manipulations, inconsistency, misclassification, and errors during measurement. However, it is still the most appropriate

business valuation model and the pitfalls can be collected through engagement of agents like auditors.

## **References**

Stanley, Morgan. " Valuation, Capital Budgeting, and Disclosure." Journal of Applied Corporate Finance (2007): 60-71.