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## **Cash flow method application of defects and their solutions**

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**Abstract:** Cash flow method(DCF model) is based on the enterprise during a certain period in the future business activities of free cash flow discount method, calculate the enterprise value of the current [1]. This method firstly get widely used in western enterprise value appraisal, introduced into China in beginning as replacement cost method, and other means of verification, the current has been independent for use as a mature method in enterprise valuation, especially in the widely used in the process of corporate takeovers and mergers.

**Keywords** *Cash flow; Application of defects; Solutions*

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### **I. INTRODUCTION**

Application in the process of the current cash flow method, has several obvious defects: one is using segmented discount lack of the determination of the time period according to the technology, no matter how different between enterprise status, usually period as a time period, which is 10 years; 2 it is all cash flow forecast, we assume that the early or late one-time flow or flow enterprise; Three periods is the discount rate is consistent:

### **II. SCIENTIFIC SETTING BOUNDARIES OF INCREASE**

To change the current value of the cash flow method is widely used in 10 years time, need according to the enterprise actual situation to determine scientifically piecewise cycle, thus achieve the purpose of correct value [2]. Piecewise discount method in practice there are a variety of ways, such as the investment guru warren buffett enterprise evaluation by many as an international well-known enterprise, the product and the stability of the market the enterprise is usually divided into two stages, the first stage is usually set to 10 years, this one phase is defined as a corporate excess return on stage, the second phase is 10 years later, this phase is defined as enterprises to maintain the sustainable and stable low growth stage, the two stage model. This model is applicable to all enterprises, the answer is no. Taiwan, for example, the appraiser for general evaluation of high-tech enterprises usually adopt three phase model, such as the first stage for 3 years, 4 years to 10 years for the second stage, ten years later for the third phase. For the sales is still in a loss but fast-growing start-ups, you should use at least four stages, that is to say, at least to cover the first stage of the dark ages.

Segmented discount method in practice use is reasonable, the key is to see the enterprise life cycle, the future of macro environment, industry characteristics and some factors on enterprise development strategy, grasp accurate basis for the future on the one hand is to the right, on the other hand is to each stage contains a shorter period of time. Enterprise's cash flow should be a smooth curve changes, and the appraiser's periodic prediction is divided into a straight line, the fitting degree of both in the macro grasp the right circumstances, stage segmentation is a good method, but in the process of practice, convenience and economy, etc, all request to appropriate subdivision level.

### **III. CASH FLOW FORECASTING ACCURACY ENHANCEMENT**

At present in the forecast of cash flow, all assume that free cash flow in the early or late disposable out or into the enterprise, this assumption does not accord with the actual situation of enterprises obviously, use one of the reasons for this approach is to simplify the operation, 2 it is enterprise's actual cash flow for the future is difficult to have an accurate understanding, especially for new businesses or enter a new field of valuation.

To solve this problem must have a few premise, is investing in person or by domain or industry has a deep understanding of, the second is about the future of the enterprise operation mode and policy orientation have a relatively accurate understanding [3]. Under the premise, analyze the future cash flow, the normal operation can be divided into the month defines the monthly cash flow, and improper operation, such as foreign investment and investment aspects as far as possible according to the actual fixed assets investment outflow segment, as far as possible, conform to the enterprise actual situation in the future.

Estimates of future free cash flow at the same time, depends on the future of the enterprise life cycle, according to the future of the enterprise life cycle infer the future periodic income, cash flow phase and its way generally similar, between phase flows tend to have relatively large differences, thus estimate of the cash flow also depends on the understanding and grasp of enterprise life cycle.

### **IV. APPLICATION OF IMPROVEMENT ON THE RATIONALITY OF THE DISCOUNT RATE**

Currently in the process of valuation, folded in half rate estimated mostly assumes that each phase of the discount rate is consistent, without considering the change of economic environment in the future. Adopt the method of reason: it is a simple, 2 it is difficult to issue for the future economic situation accurately estimate, and schedule to determine the discount rate is difficult. But it obviously does not accord with the actual situation, need to be improved in the application.

Solution to this problem has several, one is subjective to determine the discount rate change trend, for example, according to a certain range is increasing or declining; 2 it is to the discount rate, the sensitivity analysis of the change; Three is to use Monte Carlo simulations to determine the discount rate and its change.

The first method USES the change of the discount rate, can be divided into phase shift (1, 3 years, five years, etc.) and continuous change. Because this method is mainly rely on the experience of the appraiser for judgment, so need to get out sufficient evidence to explain the basis for change.

The second method based on sensitivity analysis principle, namely the answer change if the future a certain period, discount rate, will produce what results? At present, the most simple and practical method is the basis of the appraiser to determine the best expected discount rate, positive and negative float 5%, 10% and 20%, respectively, according to the output results to determine whether a best discount rate reasonable [4]. In addition, the sensitivity analysis also can be changed to the scope of weighted, the predicted results more objective.

The third basic principle of Monte Carlo simulations to determine the discount rate is set up on the basis of the probability density function, provides a series of the probability density function of intuitive graphical options available to policymakers, the probability density function can be used to describe the size of a variable appears likely, the discount rate should not be a single constant value, on the contrary, it should be

within a certain range floating the size of the occurrence probability of a set, and the probability and restricted by other factors.

## **V. CONCLUSION**

In conclusion, the design of the cash flow method in enterprise valuation principle is scientific, but in the process of practical application, piles, inflows and outflows estimate and to determine the discount rate must undergo rigorous analysis to determine, is one aspect of the problem will affect the correctness of the evaluation results, and to determine the three aspects require appraiser must be on the company's industry, strategy, life cycle, management, product and customer all aspects such as deep understanding and research.

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