ICAI RVO Registered Valuers Organisation

G20 भारत 2023 INDIA

Pages 44, January 2024 I Quarterly

THE VALUATION PERSPECTIVE

(Internal Circulation only)

RESEARCH JOURNAL OF ICAI REGISTERED VALUERS ORGANISATION (ICAI RVO)

(A Section 8 Company promoted by ICAI & Registered as a RVO with IBBI)

"Valuation is neither an art nor a science. It is a craft that can be honed and worked upon…..
— Aswath Damodaran"

ARTICLE

VALUATION OF INVENTORY UNDER INSOLVENCY AND BANKRUPTCY CODE

CA. Pawan Kumar Singal

(The author is a Chartered Accountant & a Registered Valuer. He can be reached out at pawansingal50@gmail.com)

INTRODUCTION

Valuation of assets of corporate debtor under the Insolvency and Bankruptcy Code, 2016 ("Code") is a core feature of the entire Corporate Insolvency Resolution Process ("CIRP") since it helps the Committee of Creditors ("CoC") to take a conscientious decision on the viability of a resolution plan. Valuation report also acts as a yardstick for the CoC to negotiate with prospective resolution applicants to ensure effective asset maximisation of the corporate debtor.

Regulation 27(1) of CIRP Regulation 2016 ("Regulations") requires a Resolution professional to appoint two registered valuers to determine the fair value and the liquidation value of the corporate debtor in accordance with regulation 35, within seven days of his appointment but not later than forty seventh day from the insolvency commencement date.

DILEMMA ABOUT CLASS OF ASSETS OF INVENTORY

The Insolvency and Bankruptcy Board of India ("IBBI") register valuers for three classes of assets namely: 'Plant and Machinery', 'Land and Building' and 'Securities or Financial Assets'. Neither the Code nor Regulations has defined class of assets in which inventory will be categorised. Inventory is a movable tangible asset just like plant and machinery and does not have characteristics of securities or financial assets. Financial assets are non-physical assets that have a contractual value only. Financial instruments or securities refer to a contract that generates a financial asset to one of the parties involved, and an equity instrument or financial liability to the other entity.

IND AS-2 on "Inventory" defines Inventory as:- "Inventories are assets:

a. held for sale in the ordinary course of business;

b. in the process of production for such sale; or

c. in the form of materials or supplies to be consumed in the production process or in the rendering of services."

Inventory basically includes:-

I. Finished goods that are purchased or produced completely and awaiting sale.

II. Work-in-progress – Materials that are introduced into the productions process but yet to be completed into a finished good.

III. Raw materials, components, stores, and spares (all together as Raw Materials) - Goods that are yet to be introduced into the production process are the raw materials.

It is important to note that INS AS -2, excludes following from its scope:

a) Financial instruments

b) Biological assets

c) Agricultural and forest products held by producers after harvest,

d) Minerals and mineral products measured and valued as per well-established practices of those industries.

Inventory also excludes all goods or assets that are subjected to depreciation and is to be treated as property, plant or equipment.

"Nature of Inventory which is to be valued is to be carefully examined before engaging valuers and defining their scope of engagement."

Therefore, an item which is Plant & Machinery for one company may be an inventory for another company and therefore needs to be measured and valued in accordance with IND AS 2 only. For instance, A vehicle will be treated as inventory for a manufacturer of vehicles but will be a fixed asset for an entity wherein it is part of its fleet.

In view of the above, Resolution Professional often remains in dilemma in which class of assets inventory be included and accordingly, registered valuer(s) be appointed. Generally, in a real estate company, inventory of unsold fully constructed flats or under constructed flats are treated as a part of Land and Building and accordingly, is valued by valuers registered for Land and Building class of assets. However, for other corporate debtors, particularly engaged in manufacturing of capital goods, the decision is not easy as, no guidelines has been issued so far by IBBI in this regard.

Disciplinary Committee of IBBI in its order no IBBI/Valuation/Disc./12/2023 dated 19th April 2023 in the case of Mr. Asim Maity stated that as per the norms, generally followed, the Inventory is included while assessing the value of Securities or Financial Assets. However , in appeal, Mr. Ashim Maity argued that there are no set norms relating to valuation of inventories and there is no statutory embargo on Registered Valuer of Plant and Machinery for not valuing the inventories. It is purely the subject matter of the scope of engagement.

Generally, valuation of inventory should be in the scope of valuer of Securities or Financial assets. However, wherever valuation of inventory requires technical expertise, say in boiler and other heavy machine manufacturing company or real estate company, resolution professional may appoint other class of valuers for valuation purposes by recording reasons.

DIFFERENCE IN VALUATION OF INVENTORY UNDER CODE AND FOR FINANCIAL REPORTING PURPOSES

For financial reporting purposes, inventory is valued in accordance with Ind AS 2, which prescribes that the inventories shall be measured at the lower of cost and net realisable value.

Cost

Cost includes:

a) Cost of Purchase which shall include non-cenvatable taxes, transport, insurance and handling.

b) Cost of Conversion - Fixed Overheads + Variable Overheads

c) Other Cost - Cost incurred in bringing the assets to their present location but excludes :

   a) Abnormal Waste

b) Storage Cost (unless necessary for the production process)

c) Admin Overheads not related to production

d) Selling and distribution Cost

e) Interest Cost

Book value of inventory based on historical costs, completely ignores the value created as the inventory, moves up the value chain. Profits earned and value added in the production process, which generally reflect the return on the inputs utilised, are not considered in case inventory has been valued at cost. Hence it is generally lower than the fair value of inventory.

Net Realizable Value (NRV)

Net realisable value means an estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated costs to make the sale. The book value of inventory based on net realisable value considers the value to be generated in the complete value creation process including the margins that will be generated post valuation date through the activity that are pending to be undertaken on the inventory before it can be sold. Hence it is generally higher than the fair value of inventory.

Another major difference between the net realisable value and the fair value is that net realisable value is entity specific value while fair value is market based. Hence Net realisable value for inventories may not be equal to fair value less cost to sell.

Pursuant to Regulation 27(1) of Regulations, valuers are required to determine the fair value and the liquidation value of the corporate debtor.

Fair Value

As per ICAI Valuation Standards, Fair Value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the valuation date.

Key aspects of Fair Value as per Ind AS 113 include:

a) Fair Value is based on the exit price i.e. the price that would be received to sell an asset, not the transaction price or entry price or the price that was actually paid for the asset.

b) Fair Value measurements should consider characteristics of the assets being valued such as the condition, location, restrictions associated with the sale or use of an asset as applicable.

c) Fair Value emphasizes the concepts of a "principal market" and the "most advantageous market" with respect to the business/asset being valued. In the absence of a principal market, the most advantageous market should be considered. The most advantageous market is the market that maximizes the amount that would be received to sell a given asset after taking into account transaction costs and transportation cost.

For valuing an inventory at fair value, it is extremely critical to understand the economics of the value chain. An entity undertakes with the sole objective to earn profits and therefore, final selling price of inventory includes all the related profits that it expects to earn for value created by undertaking the entire production and sale process. All expenses are incurred by any entity with a single objective of earning profits and hence value is added at every single stage right from procurement to sale

Liquidation Value

As per Regulation 2(k) of Regulation, Liquidation value means the estimated realizable value of the assets of the corporate debtor if the corporate debtor were to be liquidated on the insolvency commencement date .

As per International Valuation Standards 2017, Liquidation Value is the amount that would be realised when an asset or group of assets are sold on a piecemeal basis. Liquidation Value should take into account the costs of getting the assets into saleable condition as well as those of the disposal activity. Liquidation Value can be determined under different premises of value:

a) An orderly transaction with a typical marketing period, or

b) A forced transaction with a shortened marketing period

Thus, Liquidation value is the amount that will be realised on sale of an asset or a group of assets when an actual/hypothetical termination of the business is contemplated/assumed.

ADJUSTMENT NEEDED IN REPORTED INVENTORY VALUE IN FINANCIAL STATEMENT TO ARRIVE AT FAIR VALUE AND LIQUIDATION VALUE

As stated earlier, inventory is valued for reporting in financial statement at lower of cost and net realizable value. Since, as per IND AS-2, cost excludes interest, holding cost, administrative overhead etc, therefore, if inventory is valued at cost in financial statement, then, these costs need to be factored to arrive at fair value. Further, in case of inventory of finished goods and WIP, appropriate profit margin and cost of using intangible, may also be added to cost, to arrive at fair value of inventory, if prevailing market price of such goods warrant so. Adjustment in reported value of inventory would also be needed, to the extent of increase in prices of raw material due to inflation or purchasing of such stock during season time for calculating fair value of such inventory.

However, any valuation of inventory at realisable value in financial statement, indicate that corporate debtor is not expected to realise even cost from sale of inventory which may be due to product becoming stale or deterioration in quality during storage or defective products etc. Such realisation value would be more or less liquidation value of such inventory.

In the case of goods produced to order such as machinery, garments etc, valuer needs to factor in obsolesce losses also to arrive at fair value of inventory due to restricted market of such inventory.

METHODOLOGY FOR VALUATION OF INVENTORY

Valuation of inventory under Code i.e. fair value and liquidation value, is substantially different than the valuation for financial reporting purposes, which is measured in accordance with IND AS -2. Further, valuation for financial reporting purposes is carried out by management (which has all kind of resources and information both technical and commercial) and auditor merely expresses its opinion after carrying out audit procedures. However, valuers carrying out valuation for resolution professional or liquidator, seldom have such detailed information and technical resources and therefore, have to depend upon their own knowledge and wisdom, valuation reported in financial statement and external available information only to value inventory.

Approaches to value Inventory:
- **Market Approach**
- **Income Approach**
- **Cost Approach**

As per ICAI Valuation Standard 103-"Valuation Approaches and Methods" there are three different approaches to value inventory i.e. Market Approach, Income Approach and Cost Approach to value an asset. In addition to the methods prescribed in ICAI Valuation Standard 103, there are two other approaches i.e., the Top-Down Method or the Bottom-Up Method. Both these methods are variants of all three approaches i.e., Cost, Market and Income only. The Top-Down method begins with estimating the selling price and deducting remaining costs and estimated profit on such further activities which are allocable to future actions to be taken post valuation date. On the other hand, Bottom-Up Method begins with the book value of inventory and adjusts same for returns on manufacturing assets and processes. It can be used to cross check the valuation results from Top-Down Method. The Bottom-Up Method can also be considered for such valuations when the valuer is not able to obtain sufficient and appropriate data to use the Top-Down Method. The choice of valuation methodology should be determined based on various factors including the premise of value, availability of reliable information etc.

CONCLUSION

Resolution Professional should carefully examine nature of inventory to be valued, before engaging valuers and defining their scope of engagement. Similarly, valuers should carefully examine methodology, followed by statutory auditor, for valuing inventory for financial statements before taking any decision about the adjustments needed therein, to arrive at fair value and liquidation value.

References:

- *Concept paper on valuation of inventory by Valuation Standards Board and ICAI registered valuers organisation*
- *IND AS-2 "Inventory"*