Comments on proposed IVS 230 - Inventory

Overview

While we have detailed comments on this consultation draft which we make later, our overriding concern is that this subject, and the style of content proposed is unsuited to being an International Valuation Standard as these are now defined.

This proposed standard is addressing valuations for a specific purpose that, in a global context, is relatively uncommon compared with other purposes to which the IVS may be applied. It is also inconsistent to issue supposedly mandatory requirements for such a niche purpose when previously issued advisory content on the far more commonly required purposes of valuations for financial reporting generally and loan security where withdrawn in 2017. IVSC can have a role in providing thought leadership on specialist areas of valuation activity that have a global application, but this should be distinct from the standards. Furthermore, in spite of its designation as a mandatory standard the draft is a description of various methods that may be used and matters that may need to be considered. The recognition that the valuer has options means that the draft is mostly written using the language of guidance and therefore it is incongruous to present this as a mandatory standard.

The significant majority of responses received to proposed changes to the standards during the decade prior to 2017, including some made by current Board members, indicated that the IVS needed to include both mandatory requirements and guidance to illustrate and support the application of those requirements. However, constituents also considered it was important to make a clear distinction between the two. The detailed consultations that took place with the major VPO members of IVSC to identify obstacles to their adoption of the IVS reinforced this message. One of the action points that the IVSC committed to in the MoU signed in 2014 with 20+ VPOs was to further improve the distinction between the mandatory and advisory content.

In spite of this, the Board decided that the 2017 and subsequent editions should contain only mandatory statements, and material that had previously been advisory was reclassified as mandatory, or occasionally “presumptively mandatory”. While designating all content as mandatory is one way of distinguishing requirements from guidance, this works only if material which could and should be mandatory is included. However, the Board simply redesignated as mandatory material which had been previously presented as information or guidance as part of a non-mandatory Framework that accompanied the standards. The prime examples of this are the current IVS 104 and 105.

Consideration of other international standards used in the financial markets indicates that providing supporting material alongside mandatory is commonplace if not the norm. For example, the IFRS Foundation issues Illustrative Examples alongside many of its standards, including IFRS 13 Fair Value Measurements. The IAASB auditing standards contain a section “Application and Other Explanatory Material”. Not only has previous experience within the IVSC shown that non-mandatory supporting material is necessary, but this is the model adopted by standard setters who have achieved levels of recognition and adoption that remain a distant aspiration for the IVSC.

If financial reporting standards, which define and set the criteria for a single product - an entity’s published financial statements - consider it necessary to issue guidance, this must surely apply even more to valuation standards designed to apply to far more diverse ranges of products and circumstances. The great diversity of the valuation universe also means that the mandatory provisions in the IVS need to be confined to fundamental principles for delivering a valuation assignment that a) protect the interests of those who will rely on valuations and b) are applicable to most valuation types and purposes. These mandatory principles then need supporting with guidance to illustrate how the required objective can be met in different circumstances and markets. When working at a global level, a standard setter cannot possibly cover every conceivable application or fact pattern, and therefore this supporting material can never be presented as either comprehensive or quasi mandatory. It should be presented as a tool to enable valuers to use their judgement as to the most appropriate way to achieve the mandatory outcome.

This is particularly true of valuation methods. Within each of the three main approaches multiple variations exist of methods that have evolved in different markets. These methods reflect the data available and how this is used by market participants in pricing. In other words, the valuer should be led by the market, not vice versa. It is in the interests of those relying on valuations that the valuer adequately explains how the valuation opinion has been derived, but not that a valuer is constrained from using the most appropriate method because this is not consistent with a mandatory directive issued by the IVSC on what methods can be used and how they must be applied.

The Board's current policy that the IVS should contain only mandatory statements is therefore not only contrary to the format that other global standard setters have found appropriate but will also create an obstacle to the wider adoption and recognition of the IVS. If it were to result in valuers believing that only the methods mandated by the IVS may be used it will risk the inappropriate application of those methods and be contrary to the wider public interest. It is NOT the role of the IVSC to instruct people how to value but to maintain standards that are aimed at ensuring those relying on valuations understand them and trust those providing them.

While the draft raises issues that are relevant to a specialist area of valuation, and the IVSC is a useful forum for debating and raising awareness of the issues that arise in valuing inventory, we urge the Board to issue this as something other than a mandatory statement. A similar misstep was made with the hugely extended commentary on Discount Rates in IVS 105 made in 2019. Such material should be clearly distinguished from the mandatory standards and presented as illustrative guidance, supporting information or something similar.

The draft AICPA Practice Guide which is referenced in the Introduction to the Consultation Draft is also clearly presented as "*non-authoritative guidance and illustrations for preparers of financial statements, independent auditors, and valuation specialists.*" Notwithstanding the problem for the global projection of the IVS if it appears that its agenda is driven by issues arising in the USA, having mandatory material issued by IVSC alongside non-authoritative guidance issued by AICPA makes little sense.

Responses to Consultation Questions

1. **Please provide any comments or suggested edits to the draft standard for consideration by the Boards**.

   See later "Additional Comments".

2. **Are you aware of additional applicable guidance not cited in this Exposure Draft?**

   This question exposes a lack of clarity in the Board's thought processes. If the draft **is** intended to be guidance, then it should not be presented as a mandatory IVS. Neither does the draft standard cite any guidance, unless the question relates to the AICPA, OECD and

FASB guidance referenced in parts I-III of the consultation document, which according to the text are not part of the proposed standard.

3. **Are you aware of additional methods or best practices to value inventory not cited in this Exposure Draft?**

   Not specifically, but our long experience of standard setting informs our belief that there almost certainly will be. For example, the "Top Down" and "Bottom Up" methods described are hardly unique, being very similar to other methods used for valuing different types of assets. The inputs to these methods vary but the mechanics are basically the same.

4. **Do you believe that the addition of IVS 230 to IVS will help reduce diversity in practice and enhance practice with regard to the valuation of inventory?**

   No. Issuing this material as mandatory statement will do nothing to reduce diversity. For a minority of situations where the fact pattern means that the methods and considerations mandated by this proposed standard are reflective of best practice, it may be adopted. However, there will be many more situations where use of the methods as described will be inappropriate, meaning that the valuations will have to be provided outside of the IVS. If global standards attempt to impose mandatory methodology founded on the experience of one market it becomes more likely that the standards as a whole will be rejected as irrelevant in markets that have different experiences. Attempts to widen the scope of mandatory material in this way weaken rather than strengthen the authority of the IVS and will ultimately lead to greater diversity.

5. **Do you agree with the classification of the Top-Down Method and Bottom-Up Method under the Income Approach? If not, do you believe they would be more appropriately classified under the Market or Cost Approach, or under a new category such as the Hybrid Approach?**

   Yes. The categorisation of methods into the Market, Income and Cost Approaches was adopted by the IVSC as a convenient shorthand to indicate broad categories of methods that may be appropriate. This was when IVSC recognised that it was inappropriate to make the use of any particular method mandatory and designated discussion of methods that may be appropriate in given circumstances as guidance or supporting information. In this context precise definition or explanation of each category of approach was unnecessary.

   These categories were never intended to be absolute. There are many methods or techniques that include elements that might arise in two or three of these categories. For example, most methods involve elements of comparison or substitution regardless of whether they are categorised under the Market, Income or Cost Approach. No useful purpose whatsoever would be served by introducing a Hybrid Approach. Indeed, introducing it would just create an unnecessary distraction from the issue that matters, the use of an appropriate method. Most importantly it would be of no benefit to valuation users.

6. **Do you agree that real property assets should be excluded from the scope of IVS 230?**

   We disagree. The reason given in the Introduction and draft that real property inventory is covered in IVS 410 is fundamentally flawed, for reasons explained under "Additional Comments" below. Real Property can be categorised as Inventory depending on how this is defined in any regulations that determine the scope of the valuation being undertaken. For example, under IFRS a housebuilding firm will account for its stock of land, houses that are under construction or completed pending sale as inventory under IAS 2. The criteria and valuation techniques used are similar to those used for any other type of work in progress, although different terminology may be used. If the draft is reclassified as guidance it is then the Board can make the scope as narrow as it likes, but if it believes that there should be mandatory requirements for inventory valuation that differ from those already stipulated for undertaking any other type of valuation provided in IVS 1-3, then those requirements should be as generic as possible and not exclude any type of inventory if they are to be effective.

Additional Comments

Introduction and Findings:

We understand that Sections - I-III are not part of the proposed standard. However, we are concerned that the preamble to this draft is very USA centric with extended references to the AICPA and FASB material on inventory which both precede and are more extensive than the reference to IAS 2. While it is appreciated that the USA has the most well developed business valuation profession the Board must bear in mind that the IVSs are intended to apply globally and must therefore appear relevant to a global audience. Consequently all material, even if written by persons with only US experience, should be careful to avoid giving the impression that it has been prepared only to address issues arising in US markets. We urge the Board to ensure that this is reflected in any material that accompanies the release of this guidance.

20.2. Scope:

Whether an item is classified as inventory depends on how it is used not the nature of the item. The exclusion of real property from the scope is therefore unnecessary as real property can be either classified as inventory or as a fixed asset.

One problem with excluding real property from the scope of any guidance on inventory is that the identification of inventory, including some of the components discussed in Section 90 of the draft, is an important consideration in the valuation of real property interests that are normally sold as part of an operational business, for example hotels, hospitals, care homes, sports and leisure facilities etc. In order to value the property interest in isolation, the contribution to total revenue from matters such as internally generated goodwill or activities not associated with the property interest need to be analysed. Since there is no guidance in the IVS for valuing real property of this type, indicating that the proposed guidance is not applicable to real property effectively highlights a void in its overall guidance. We urge the Board to encourage the Business Valuation Board and the Tangible Assets Board to collaborate in producing a wider ranging piece of guidance that focuses on the common principles of valuing inventory rather than creating arbitrary boundaries based on its current internal organisational structure.

The statement that the valuation of real property is covered in IVS 410 "Development Property" is also misleading. As the title of 410 indicates, it is concerned only with real estate for which development is planned or is in progress. While such property may sometimes be classified as Inventory under IAS 2, if it is to be held for owner occupation it falls under IAS 16 and if intended for future income or capital appreciation it is accounted for under IAS 40. Inventory can also include real estate where development is neither planned nor in progress. As stated above, our preference would be to see generic guidance on

Inventory applicable to any item that may be classified as inventory but if real estate is to be excluded and a cross reference is required, both IVS 400 and 410 should be mentioned.

A related point is that it is inappropriate to designate guidance on valuation issues that may affect other major asset classes identified in the IVS as being a subset of business valuation in the 200 series. Doing this further obfuscates the potential relevance of the content to real property, plant and equipment, all of which are capable of being classified as inventory. The proposed designation indicates confusion of the purpose for which a valuation is required with the type of asset to be valued, which is inconsistent with the requirements of IVS 101.

40.1 Valuation Approaches:

We do not understand the sentence "*If necessary for the valuer to classify a method under one of the three Approaches, the valuer should use judgement in making the determination and not necessarily rely on the classification below."* There is no need for a valuer to ever classify a method under one the three approaches. According to IVS 105 10.5 it is the valuer's responsibility to choose the appropriate method(s) for each valuation engagement. Whether this method might be "classified" as falling in either the market, income or cost approach is irrelevant. The approaches discussed in IVS 105 are not three holy pillars of valuation but simply a convention for grouping together methods with broadly similar characteristics, just as a telephone directory typically groups numbers according to the alphabetical order of subscribers' names.

Generally:

The term "book value" is used throughout the draft, particularly as an input into the "Top Down", "Bottom Up" and "Current Replacement Cost" methods. Book value is commonly used as a synonym for the carrying amount in an entity's financial statements. The most common reason for which inventory requires valuation is to determine the appropriate carrying amount. Therefore the draft appears to describe methods that use the required result as one of the inputs needed to calculate it. A better explanation is required that avoids this circularity. We suspect that the intention of the author was for historic cost to be the input given that the existing book value may well be the carrying amount derived from a previous valuation exercise.

110.2 Accounting or Valuation?

This paragraph introduces the term "net realisable value". This raises two questions. Firstly net realisable value is an accounting definition, which appears both in IFRS and US GAAP, albeit with slightly different definitions. It is not a term that is defined anywhere in the IVS. Given that the draft has previously made it clear that inventory may need to be valued for purposes other than financial reporting, what is its intended meaning here? Secondly, the whole of section 100 seems to refer to an accounting rather than a valuation function. Given the stated scope of the paper is not confined to valuation for accounting is any of this section appropriate for inclusion?

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