CONCEPT OF VALUATION UNDER IBC

1. Overview

The need and requirement of valuation under Insolvency and Bankruptcy Code 2016; is an important area for Registered Valuers under all three asset classes- Plant & Machinery, Land & Building and Securities or Financial Assets. IBC along with Rules and Regulations framed thereunder, have laid down the basic regulatory requirement-

As per Regulation 27 of IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 ("CIRP" Regulations), the Resolution Professional shall within seven days of his appointment, but not later than forty-seventh day from the insolvency commencement date, appoint two Registered Valuers to determine the fair value and the liquidation value of the corporate debtor in accordance with regulation 35:

CIRP Regulations also specifies that the following persons shall not be appointed as Registered Valuers, namely:

a. a relative of the Resolution Professional;

b. a related party of the Corporate Debtor;

c. an Auditor of the Corporate Debtor at any time during the five years preceding the insolvency commencement date; or

d. a Partner or Director of the insolvency professional entity of which the resolution professional is a partner or director.

2. Framework of Valuation under IBC

The term Fair Value and Liquidation Value have been defined under CIRP Regulations as follows:

Clause 2(hb): *"Fair Value" means the estimated realizable value of the assets of the corporate debtor, if they were to be exchanged on the insolvency commencement date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had acted knowledgeably, prudently and without compulsion.*

Clause 2(k): *"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.*

It is good that the IBC has defined the terms 'Fair Value and Liquidation Value'; instead of leaving it open ended. However, the concept of Fair Value and Liquidation Value has to be looked at under larger perspective of internationally accepted valuation standards, Accordingly, it is worthwhile to review the standards laid issued by RVO like ICAI RVO as well as well as by IVSC such as IVS 104.

As per Regulation 35 of CIRP Regulations, the Fair Value and Liquidation Value shall be determined in the following manner: -

a. the two Registered Valuers appointed under regulation 27 shall submit to the Resolution Professional an estimate of the Fair Value and of the Liquidation Value computed in accordance with internationally accepted valuation standards, after physical verification of the inventory and fixed assets of the Corporate Debtor;

b. if in the opinion of the Resolution Professional, the two estimates of a value are significantly different, he may appoint another Registered Valuer who shall submit an estimate of the value computed in the same manner; and

c. the average of the two closest estimates of a value shall be considered the fair value or the Liquidation Value, as the case may be.

3. The Concept of Fair Value and Liquidation Value

A. International Valuation Standards 2017

As per International Valuation Standards 2017 (IVS 104 Bases of Value), the term Fair Value and Liquidation Value are defined as follows:

Liquidation Value

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

A valuer must disclose which premise of value is assumed.

Fair Value
(International Financial Reporting Standards)

IFRS 13 defines Fair Value as 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 measurement date.

B. ICAI Valuation Standards, 2018

Fair value: *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.*

It can be seen that the definition of 'Fair Value' is identical to the definition given under Ind AS 113.

Liquidation value: *It 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.*

4. **<u>Fair Value Measurement under Ind AS 113</u>**

Ind AS 113 – Fair Value Measurement throws light on fair value measurement and has given hierarchy of inputs for fair value measurement. The valuer under IBC can draw principles of fair value measurement from Ind AS 113 keeping in mind the differences in the fair value as per IBC vs Ind AS 113.

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

A. (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. Generally, entry and exit prices are different. The idea of exit price is based on expectations about the sale or transfer price from the perspective of market participants as of the valuation date.

(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. The principal market is defined as the market with the greatest volume and level of activity for the subject asset or liability. Ind AS 113, specifies that 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 costs.

(d) The highest and best use of a nonfinancial asset or group of nonfinancial assets is the use by market participants that maximises the value of the nonfinancial assets. This Fair Value concept considers:

i. the different ways of utilizing the individual asset/liability, i.e. the highest and best use, and

ii. the valuation premise, whether the maximum value is on a standalone basis or in combination with other assets.

(e) Fair Value measurements should reflect market participant assumptions in pricing an asset. Market participants are assumed to be buyers and sellers in the principal (or most advantageous) market that are knowledgeable independent, unrelated parties willing and able to transact for the asset being Fair Valued without compulsion.

B. Fair Value hierarchy: To promote consistency and comparability in fair value measurements, Ind AS 113 establishes a Fair Value hierarchy that categorises valuation related inputs into three levels, namely:

a. Level 1 inputs - these inputs are quoted prices (unadjusted) in active markets for identical assets that the entity can access at the measurement date. As a quoted price in an active market provides the most reliable evidence of Fair Value, it should be used to measure Fair Value whenever available. Common examples of Level 1 inputs include listed equity securities and open-ended mutual funds with daily published net asset values.

b. Level 2 inputs - these inputs are other than quoted prices included within Level 1 that are observable for the asset either directly or indirectly. Level 2 inputs include:

   i. quoted prices for similar assets in active markets;

   ii. quoted prices for identical/similar assets in markets that are not active;

   iii. inputs other than quoted prices that are observable for the asset, such as interest rates, yield curves, implied volatilities and credit spreads; and

c. market-corroborated inputs. Adjustments to Level 2 inputs vary depending on factors specific to the asset, such as:

   (i) condition or location of the asset;

   (ii) the extent to which inputs relate to items that are comparable to the asset; and

   (iii) the volume or level of activity in the markets within which the inputs are observed.

d. Level 3 inputs - these inputs are unobservable inputs for assets. Unobservable inputs are used to measure Fair Value to the extent that relevant observable inputs are not available. The unobservable inputs should reflect the assumptions that market participants would use when pricing the asset, including assumptions about risk. An entity should develop unobservable inputs using the best information available. In developing unobservable inputs, an entity may begin with its own data, but it should adjust the data to ensure consistency with a market participant view point. Common examples of Level 3 inputs include management prepared business forecasts utilized in a discounted cash flow model.

C. In estimating the Fair Value of an asset, the valuer should use the valuation techniques that are appropriate in the circumstances and for which sufficient data is available to measure Fair Value, so as to maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

5. <u>Analysis of measuring of Fair Value & Liquidation Value</u>

The definition of Fair Value and Liquidation Value are not radically different under IBC, IVS and ICAI Valuation Standards. IVS 104 Bases of Value states under para 10.2 that a valuer may be required to use bases of value that are defined by statutes, regulations, private contracts or other documents. Such bases have to be interpreted and applied accordingly.

The definitions under IBC clearly state the ‘Valuation Date’ which is the ‘Insolvency Commencement Date’; thus, restricting the discretion of Insolvency Professional or Registered Valuer in this regard.

6. Practical Challenges

A. As mentioned earlier, Fair Value and Liquidation Value are to be determined on the insolvency commencement date which is a historical date and to that extent; it is expected from the valuer to collect input and information with reference to that date. It may not be practically possible for the valuer to identify willing buyer on historical date and ascertain the Fair Value. Therefore, the valuer may have to collect market prices, published information and other publicly available data to arrive at Fair Value and Liquidation Value.

B. In large number of cases, IBC companies do not have up to date accounting information, latest audited accounts and fixed asset register. Perhaps for this reason, IBC requires the valuer to conduct physical verification of the inventory and fixed assets of the Corporate Debtor. However, there are several other buckets in which assets may fall which are not physically verifiable such as debtors, claims, loans and advances. It is advisable that in case of incomplete and missing information; the valuer shall mention it in the valuation report along with the reasonable assumptions made to arrive at Fair Value and Liquidation value.

C. In case of debtors, loans and advances and claims against third parties; the verification of following documents could be helpful to arrive at the value:-

i. Balance Confirmation
ii. Correspondence to ascertain efforts already made to collect/realize
iii. Dispute status
iv. Ability of the third party to pay
v. Underlying transaction resulting into such receivables.

D. The valuer is required to furnish both Fair Value and Liquidation Value on the same date, resulting in working on a hypothetical scenario. While benchmark value for Fair Value may be available from the market sources, but finding the benchmark value for Liquidation Value in each case is not feasible. This may necessitate to apply discount on Fair Value to arrive at Liquidation Value on some prudent basis.

Suggested Reading

1. Insolvency and Bankruptcy Code, 2016 and IBBI (Insolvency Resolution Process For Corporate Persons) Regulations, 2016
2. International Valuation Standards 2017 – IVS 104 Bases of Value
3. ICAI Valuation Standards, 2018
4. Indian Accounting Standards (Ind AS) 113 – Fair Value Measurement