Valuation under the CIRP process: Few Important Concepts and use in Practical Scenarios

Rajesh Kamath
The author is an Insolvency Professional (IP) Member of IIIPI. He can be reached at
iprrkamath@gmail.com

Valuation of various assets of the Corporate Debtor (CD) undergoing CIRP is very crucial in the IBC, 2016. Normally, the valuer chooses among the Income, Market, Replacement Cost and Asset Value being the main methods in addition to some other methods as suitable for valuation of specific assets. Normally, the Insolvency Commencement Date (ICD) is considered as deadline for valuation of CD under the IBC and the Valuation Report includes Fair Value and Liquidation Value of the CD. The Valuation Report, besides helping the RP in preparing Information Memorandum to invite EOI from bidders also acts as a guide in comparing resolution plans and negotiation with bidders. In addition, representatives of the financial creditors in the CoC also look at the Valuation Report to assess while considering various resolution plans for approval. In the present article, the author, through various scenarios, has presented a thorough analysis of valuation report and its importance in various IBC processes.
Read on to know more…

Valuation under the Corporate Insolvency Resolution Process (CIRP) is to be conducted by an IBBI (Insolvency and Bankruptcy Board of India) Registered Valuer of asset class like Land and Building, Plant and Machinery or Securities and Financial assets, appropriate to the composition of assets in the balance sheet of the Corporate Debtor (CD) as on valuation date. Unlike a typical valuation where the emphasis is on finding the true value of asset with latitude of time as per complexity of the exercise, this is highly time-bound exercise with strict timelines being laid down in the CIRP regulations formulated by the IBBI.

Whereas in normal valuation, the challenges of valuation parameters co-exist with the complication of complex instruments being valued which are mostly located on the liability side of the balance sheet for example equity value, debenture value, value of preference shares, value of Optionally Convertible Shares, Employees Stock Option Plan (ESOPs), additional challenges arise in CIRP valuations which focus on the asset side of the balance sheet. The CIRP valuation culminates in the fair and liquidation value of assets, which requirement is as per Regulation 35 read with Regulation 27 of IBBI (Insolvency Resolution Process for Corporate Persons or IRPCP) Regulations, 2016 or CIRP Regulations. Few of such challenges particularly encountered by a SFA (Securities and Financial Assets) valuer are illustrated as under:

1. Selection of Appropriate Method of Valuation and Date of Valuation

Normally the valuer chooses among the Income, Market, Replacement cost and Asset Value being the main methods in addition to other methods as suitable for specific assets. The Insolvency Commencement Date (ICD) is the date for valuation of the assets.

One thing which must be borne in mind as there's in CIRP excepting few cases, a serious chance of discontinuation of business, in such circumstances, the valuer may analyze the balance sheet asset side and look at asset value which is most likely valuation method. However, in a few going concern cases, the valuer may take a look at even earnings method when projections are available for future years' revenues, whichever method gives better results closer to the ground reality. Likewise, when heavy capital-intensive machinery is the only asset in the balance sheet, it may be replacement cost which is apt just to take an example.

> **The valuer may do well to exercise professional skepticism and steer clear of all dependency connotations and in case of doubts should refrain from accepting the assignment to avoid any future controversies.**

For example in case an entity with discontinuing operations, has a land bank which is rented out for an assured income, there is all likelihood that upon sale as going concern, the Successful Resolution Applicant (SRA) may enjoy this benefit for all times to come, so this must also be factored into the valuation, which may otherwise be bereft of any valuable or tangible asset and may comprise only assets reflected in books but not recoverable. So, this is important to determine which is the method leading to an apple with apple comparison and this may change the whole course of valuation unless chosen with due care and caution.

2. Disclosures of Relation

There exist provisions for related party disclosures within u/s 5(24) of the IBC for Interim Resolution Professional (IRP)/ Resolution Professional (RP), who is authorized to appoint valuer and invited Expression of Interest (EOI) from Prospective Resolution Applicants (PRAs).

The valuer may do well to exercise professional skepticism and steer clear of all dependency connotations and in case of doubts should refrain from accepting the assignment to avoid any future controversies. Care should be taken to refer to the guidelines and Circulars as issued by the IBBI in this regard from time to time. Whether asked or not, the valuer should submit this information as later on this may become a thorn in the flesh in the case of future litigation. This way the valuer can ringfence himself/herself against any allegation on his/her independence or disclosure norms.

3. Disclosure of Valuation Standards adopted

Proper disclosure of valuation standards followed for the valuation is of utmost importance and a statutory report to be taken care of meticulously. There are two primary valuation standards - Global International Valuation Standards and the Indian ICAI Valuation Standards-2018. For valuers enrolled with ICAI RVO, the application of ICAI Valuation Standards is mandatory whereas not so for valuers enrolled with other RVOs and they are free to choose whichever they prefer, however this assumption at times may significantly influence the valuation in case of conflict scenarios, so the RP needs to take cognizance of these assumptions before such valuation as in CIRP process. For example, the requirement as per the CIRP Regulations is of taking average valuation of at least 2 valuers as the fair value and liquidation value, such that the difference between the two should not exceed 25% which is treated as significant difference. For e.g. significant difference is calculated by liquidation value higher L1 less liquidation value lower L2 divided by L1, using formula (L1-L2)/L1 >=25%. (greater than or equal to 25%) for each asset class. Accordingly, there may be a need to appoint a third valuer in case this difference is significant.

4. Incomplete Information

In case of a going concern, maximum information including projections of future years are usually available. However, there may be cases where audits are not completed for a number of years. Even when later on the audit is completed, it may be the basis assumption of information as received basis. For instance, Where the audit is completed based on bank statements available with the IRP/RP, unlike all bank statements as in absence of updated accounts it may not be possible to accurately know even the number of bank accounts as there's a time gap between the time the order is passed for the CIRP vis- a- vis when the company was last audited. Likewise, during the last audit, the company would have been a going concern but not during the CIRP.

The valuer has to indulge in a comprehensive and painstaking study of the auditor's report as on the ICD and in case of provisional financial statements, the various assumptions and notes in accounts pertaining to the preparation and presentation of financial statements, including the contingent assets, if any. These assumptions may be buttressed by legal opinion or tax consultant opinion or any professional opinion suitable on case-to-case basis or RP's own opinions in case available. Management representation is also essential in several cases to close the gap between unknown to known. Moreover, they may be suitably presented pointwise against each individual asset rather than across a class of assets.

5. Physical Verification vis a vis Estimation

Whereas a land and building valuer, and plant and machinery valuer may have to physically inspect and certify assets in most cases and accompanied by strenuous travelling, and locked gates, non-handing of custody of assets, non-cooperation of the management of the CD, etc., use of technology like drones, google maps, robots, etc. may mitigate the load to some extent. However, the risk in plants and machinery which are not in use is huge with all necessary precautions to be taken to avoid any untoward incident like blasts, short circuits, etc. just to name a few. At times even security personnel may be absent from the site, adding to the stress of such valuations. The unpaid creditors and workers are at times unruly and known to physically assault or otherwise harm RP and officials accompanying management at the site, so police protection may be needed in such enhanced risk cases. The role of SFA valuer is also equally prone to these dangers in the case of stock valuations at site.

"At times even in desktop valuation, the SFA valuer may face an equally complex exercise as he may be valuing book assets which at times may be well justified."

At times even in desktop valuation, the SFA valuer may face an equally complex exercise as he may be valuing book assets which at times may be well justified, for example confirmation of book debts, bank statement for bank balance, physically verified cash on hand, etc. However, when proper custody of books of account is not received at other times, there may be book debts even without party wise break up for analysis. This may be confirmed only from entries in the bank books during the intervening period from date of last audit till the CIRP date of valuation.

In certain cases, the SFA valuer can also put a disclaimer to the extent of the uncertain balances in case of non-confirmation of the book debts or non-availability of any supporting documents to prove the debts. He may also take help with age-wise analysis of the book debts and other receivables to apply discounting on time value of money in case available in a latest audit report with minimum time difference. In case he can clearly identify non-moving debts for more than 3 years, being time barred without any communication evidence from either side, he may take as nil. These cases may all be well documented and presented in the valuation report to the extent practicable as these working papers may be essential to justify the fair and liquidation values as determined by the 2 valuers of each asset class as required in the CIRP Regulations. One more thumb rule that the valuer may follow is that each and every item as identified in the balance sheet may be analyzed and verified or estimated using his valuation techniques as suitable for the purpose as against a class of assets as a whole. For example, few valuers just take a percentage basis their judgement for class of assets instead of for each asset independently, and in many judgements of courts, the orders have called into question such valuation report as to why only x percentage and not y percentage. Hence, this is to be documented meticulously while valuing each and every asset.

For example, while valuing deposits, there may be various deposits with various authorities for example there may be an Earnest Money Deposit (EMD) which would be refundable to the CD on certain date or there may be a security deposit for an electricity connection which would be refundable if the connection is disconnected or else maybe adjusted against dues. Similarly, the third one may be a security deposit from a government PSU say HAL which will be refundable after 10 years pursuant to a maintenance contract. All these have to be carefully identified, segregated and valued accordingly with appropriate discounting applied to the time factor for realization of various assets. Proper management representation or legal papers are a must for suitable assumptions and presentation of such items in the valuation report.

6. Netting of Current Asset and liabilities vis a vis not Netting off a Claim

While this rule in general applies to all valuation, but for corporate valuation takes place of an equity share or instrument in most cases, so all the current liabilities are netted off from the total assets to arrive at net worth of the enterprise, which is divided by the number of shares/ instruments issued and paid up. However, under CIRP, claims are invited for liabilities and assets are valued by the valuer for fair value and liquidation value.

When a class of assets is subject to claim by financial and operational creditor or operational creditor being Government, the same may not be netted off as the valuation of assets is done on a standalone basis to determine the valuation of the company as a means to service the claim through resolution or through a liquidation waterfall mechanism. Under such cases, haircut on claims is very normal. So, these are necessarily ignored while valuing the assets of the corporate as on CIRP date.

> **In corporate valuation, all the current liabilities are netted off from the total assets to arrive at net worth of the enterprise, which is divided by the number of shares/instruments issued and paid up.**

Section 29 of Liquidation Regulation deals with mutual credits and set-off, whereas there's no similar Section under the CIRP Regulations. This has to be carefully examined as this is a logical exercise and can be a ground for litigation if not so done. Firstly, the valuer must ascertain what are the basket of assets subject to entry both in current asset as well as current liability reflecting a mutual claim and asset. For example, a case is subject to multiple arbitrations and there are three awards from arbitrator favoring the CD whereas two awards are favoring the creditor, the net effect of this being the amount receivable has to be considered and, in such case, the claim may not be preferred by the creditor. On other hand if the creditor does prefer a claim, the RP may take a call to accept or reject the claim and accordingly the valuer has to communicate with the RP to find out what assets are to be valued i.e. the Gross Assets or net assets post set-off of mutual liability. This is juxtaposed with a liquidation valuation wherein the valuer has to necessarily value the net assets after setting off mutual claims.

7. Fair Value and Liquidation Value

This can be analyzed as also a valuation in an orderly sale (Fair Value) vis a vis in a disorderly or an emergency sale (Liquidation Value). At times this converges in case of highly liquid assets for e.g. Cash, bank, Mutual funds, listed shares, etc. and Fair Value becomes equal to Liquidation Value.

However, most of the times liquidation value is definitely lower than the fair value due to the time value of the money for e.g. debtors, deposits, tax refunds, etc. As such, wherever reasonable estimates cannot be made due to absence of information to calculate the time value of money, few estimates and assumptions need to be made. However, as discussed earlier, these need to be made individual asset wise and not in a group or class of assets. Normally a 10-20% discount on fair value is assumed for calculating liquidation value wherever a precise or estimated calculation is not possible or practicable.

8. Fair Valuation Fluctuations post-CIRP date make it a Swinging Value

As discussed in point 1, the date of valuation being defined by Section 35 would mean to be the date of ICD. Accordingly, even though the valuer may have information closer to the valuation report date including realizations or post CIRP payments out of bank balance, etc., he may be valuing this as on ICD only. The fair value at point of Resolution Plan acceptance may be totally different so the fair value in CIRP basically is a swinging value and not a fixed one. There is never a case where this may match even to extent of a Resolution Plan being accepted at exactly the fair value. However, the intention behind the fair value was never to be matching in any case and at best it can be considered as a light house for providing light to the various ships (resolution plans) that approach the coast (evaluation matrix). As such it is expected to be doing its job fine as a benchmark indicator of value.

9. Role of Fair Value while deciding on sale as Going Concern

Normally under CIRP, once a Resolution Plan is accepted by the Committee of Creditors (CoC) basis the evaluation matrix criteria, and approved by the NCLT, the SRA takes over the CD as a going concern under CIRP Regulations, as contrasted with a liquidation as going concern wherein the CD is taken over at a successful e-auction under the Liquidation Regulations. Whilst the NCLT approved Resolution Plan may be at more or less than a fair value, the fair value provides the following valuable guideposts:

> **"The intention behind the Fair Value was never to be matching in any case and at best it can be considered as a light house for providing light to the various ships (resolution plans) that approach the coast (evaluation matrix)."**

a) When the CD is being subject to a due diligence and subsequently receives EOI and resolution plans, both RP and CoC have some guide as to how much the value perceived by the SRA differs with the valuer derived fair value and more pertinently, the reasons pertaining to the quantum of differences, if any.

b) Normally, financial creditors and CoC try to match the Fair Value while considering the Resolution Plan for approval. This enables the RP to justify his independence basis such fair values in the valuation reports obtained.

c) At times of negotiating, the CoC has at least a benchmark, so it knows how much leeway there is so that even in case of the CD being sold as a going concern at a price, the same is not considerably lower than the swinging fair value without justifications.

d) The liquidation value and fair value difference may also be kept in mind by the RP while chairing a meeting of the CoC as the CoC may be convinced in favour of going for Form G reissues instead of Liquidation in the effort of deriving the best value possible for the sale of business as a going concern as opposed to liquidating the same.

e) Time value of money may be emphasized by the RP taking fair value as a guidepost to execute resolution plans to extract maximum value out of such exercise as against delayed execution which may result in substantial impairment/ loss of value due to lack of maintenance/ no insurance or due to lack of funds/ few or no employees etc. causing worsening of the situation.

10. Valuation of Assets under Litigation

While there is no particular rule for valuation of assets under litigation, a few points have to be borne in mind while valuing such assets.

a) All legal and consultant opinions are to be vetted for ascertaining the recoverability of such assets.

b) As moratorium under Section 14 of the IBC applies to CIRP, all assets under the lien and security must also be considered for the valuation as if free from such charges.

c) Under Section 14 of the IBC, all such legal proceedings are deemed to come to an end once the order admitting CIRP is passed. Accordingly, the valuer can assign values to such assets as they appear in custody of the RP.

d) In case some litigation or court cases are going on, the valuer may study such proceedings, court orders or arbitration awards. Upon discussion with RP, the valuer may obtain suitable opinion on recoverability as mentioned in point (a) applying recovery percentage accordingly. However, in case of uncertain litigation and no particular trend of litigation being observed by RP/Management, the valuer may have to use his judgement and experience on such cases and in absence of any objective yardsticks, he may value at 50% assuming equal probability of success or failure in litigation.

> **"In case some litigation or court cases are going on, the valuer may study such proceedings, court orders or arbitration awards. Upon discussion with RP, the valuer may obtain suitable opinion on recoverability."**

11. Presentation of Valuation Report

This topic being vast, other than general rules applied in CIRP, care should also be taken to show the appointment, purpose of the valuation, date when valuation conducted and the ICD which is the date of valuation, all assumptions, limitations and caveats in a compact and concise form as against a verbose format. The valuer may or may not round off the assets as may be appropriate case to case basis looking at the materiality and volume of work as also the statutory requirements have to be fully disclosed without any compromise. At same time important photos/screenshots etc. may be depicted in a user-friendly format, adding value as well as ease of comprehension for the user. Moreover, this presentation may assist the valuer in explaining the report to the CoC.

For example, showing all methods including Income, Market, Replacement Cost and Asset Value, not even adopted in instant valuation case in a very detailed manner unless requirement of statute may well lead to attention being diverted on the format as against what the report wants to say. So brief mention may be made of unused methods, whereas detailed analysis and mention of assumptions may be used in the methods adopted for valuation exercise. Likewise, the intended users of the report, caveats and statutory disclosures for e.g. the sources of information and the fair and liquidation value of the assets valued as well as the Unique Document Identification Number (UDIN) / Valuation Reference Number (VRN) may be disclosed for a concise, compliant and compact Valuation Report.

Conclusion

The objective of this article is to provoke thoughts to meaningful analyses and interactions leading to a more valuable Valuation Report with suitable decision-making inputs which could serve the insolvency framework as per the timelines provided under the IBC. Accordingly, the IPs can take his/her own care and caution while undertaking valuation under the CIRP subject to the regulations and guidelines issued by the IBBI and judgements of various courts.