How to valuate cores in financial accounting

Including best practices

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HOW TO VALUATE CORES IN FINANCIAL ACCOUNTING?

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CONTEXT

What is the issue?

- Non-existence of guideline of how to evaluate used parts in the balance sheet
- Practice shows failed business transactions as parties could not agree to a common evaluation approach of cores
- Affects not only automotive remanufacturing but also businesses in the entire circular economy

01

CONTEXT

What is the status quo?

- For the first time a white paper for further discussion was developed and published
- Paper is based on automotive remanufacturing business case

What was the aim of the white paper?

- Develop commonly accepted evaluation methods of used parts to improve access to finance for CE businesses
- Understand whether and how existing accounting principles can be used to evaluate cores
- Reveal impact on company valuation

02 APPROACH

Accounting

Investment

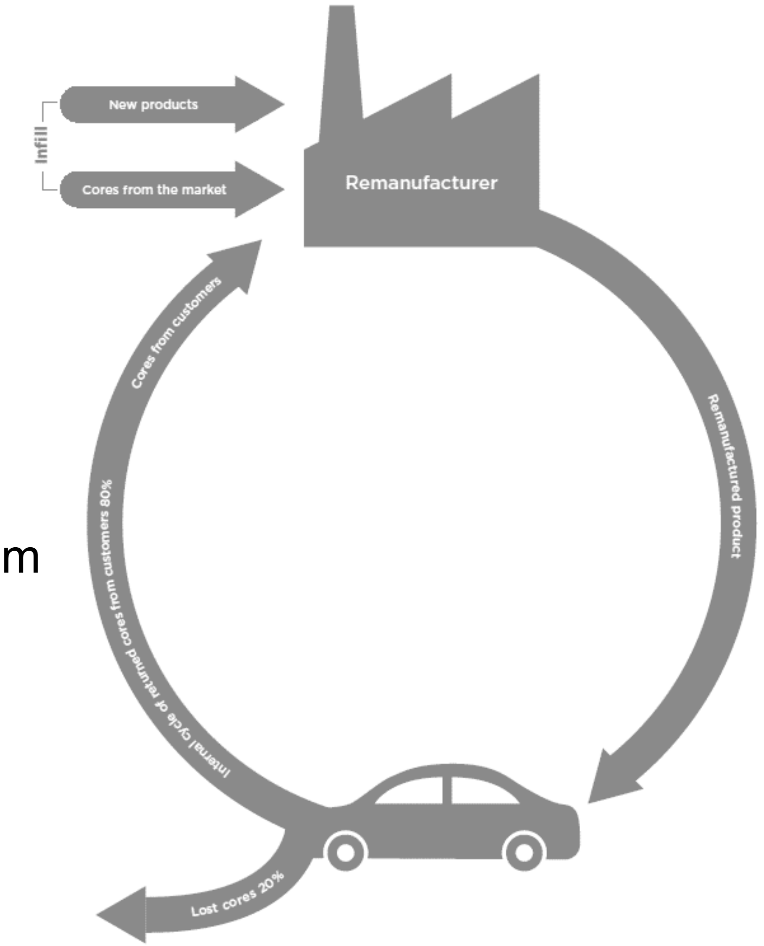
Finance

Science

Remanufacturing Industry

Remanufacturing business case in the automotive aftermarket

- Availability of cores is precondition for the business case
- Surcharge as incentive to return defective parts
- Value of surcharge is independently set
- About 80% of the core demand accrues from the internal return cycle
- Remaining 20% is procured as infill on the market



Inventory valuation according to IFRS

- **No specific standards** in the IFRS framework directly applicable for the recognition, measurement and **valuation of used parts**

IAS 2

- Applies to inventories e.g., **raw materials, production components and trading goods**
- Provides guidance for determining the ‘cost of inventories’ and the subsequent recognition of the **cost as an expense**, including any write-down to ‘net realisable value
- Is measured at the **lower of cost and net realisable value**

IFRS 13

- Applies to **non regularly traded goods** e.g., real estate
- Does not apply to inventories e.g., raw materials, production components and trading goods
- Defines **fair value as the price that would be received** to sell an asset in an orderly transaction between market participants at the measurement date

IAS = International Accounting Standards

IFRS = International Financial Reporting Standards

Impact of applying IFRS on core evaluation

- According to IFRS principles:
  - **cores** belong to **company inventories** and
  - **entire inventory** must be evaluated **at the lower of cost and net realisable value** (IAS2)
- However, this evaluation approach **does not represent the economic reality** of a company, which does not fulfill the overall goal of accounting
- High stock of cores gives remanufacturers a high scope to influence the valuation of the company

Companies implement individual evaluation strategies to represent economic reality

- So far cores are often arbitrarily evaluated: Evaluation ranges from **zero**, to **scrap value**, to **selling prices**
- This **creates uncertainty for investors** about the adequate valuation of the company

IAS = International Accounting Standards

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03 BASIS

Main valuation influencing factors of a core from an accounting perspective

RECOMMENDED APPROACH BOOKKEEPING PERSPECTIVE

In case of understocking

Cores from the internal cycle: must be valued according to the full fair market value (IFRS 13)

Core internal value = min [Core cost ; Δ P new* – R core]

Core coming as infill: must be valued at cost (IAS 2)

Infill core value = min [Core cost]

*P new = price of a new unit infill (equivalent in functionality and quality to related reman part)

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RECOMMENDED APPROACH BOOKKEEPING PERSPECTIVE

In case of overstocking

Cores must be valued by writing-down to net realizable value (IAS 2)

Core internal value = NRV

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IFRS = International Financial Reporting Standards

05

REFLECTION
INVESTOR PERSPECTIVE

Reflection of the suggested valuation approach

- Accounting rules measure value at a specific date
- An investor, in comparison, **looks at the potential of the business** to derive more value from the core than that registered on the balance sheet
- For an investor, a company with a slow-moving core inventory, written-down to net realizable value (NRV) (IAS 2), in combination with specific capabilities can lead to a high-margin opportunity (value of the company)

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06 CONCLUSION

- Existing IFRS leads to an evaluation of the company that does not represent the economic reality
- Suggestion to evaluate cores according to fair market value (IFRS 13)
- From an investor perspective, business opportunities in the future are critical for the evaluation of the company
  - This cannot be represented with accounting principles
  - Other financial instruments must be taken into consideration
- White paper as a first step to adapt accounting standards for circular economy businesses through IFRS Board

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