# Back to basics: **Net Realisable Value**

Struggling with how to value inventory? Rob Wyatt recaps the basic principles of valuing inventory using the Net Realisable Value technique

One important aim of the Statement of Financial Position is to accurately report the value of the enterprise. The 'true' value of assets is achieved in various ways using a variety of techniques and one requirement when valuing inventory is the idea of 'net realisable value' (NRV).

0NRV represents the net value, real or estimated, to the enterprise after selling costs have been considered. For example, if there is are costs required to prepare the inventory for sale then those should be deducted from the expected selling price.

In normal circumstances, NRV would be higher than historic cost, leading to potential profit, but in some circumstances such as obsolescence, physical deterioration, etc, it can be lower. The requirement for financial reporting is to use the lower of historic cost or NRV.

**How is it calculated?**

Adjustments can arise in different ways. The simplest is where obsolescence, or similar, reduces the selling price. For example, inventory bought for £5 per unit with the initial intention of selling at £10 per unit would be held in inventory at the lower value, namely £5 per unit.

However, if the market price dropped to £4 per unit then the NRV is now lower than historic cost and the value of inventory would be reduced to £4 per unit. The adjustment recorded as an expense in the profit and loss account.

Slightly more complicated are situations where the goods are damaged and require some form of repair to be placed in a saleable condition, albeit possibly with a different sales price.

Consider the example above with a different situation whereby the items need to be repaired at a cost of 35p per unit to achieve a sales price of £5.25 The sales price is higher than cost, but the repair charge must be taken into account giving an NRV of (£5.25 – £0.35 =) £4.90. Once again the inventory would be reduced to the lower value with an appropriate charge to the P&L.

**Exam tips**

1. Be careful not to simply adjust to NRV. Adjusting the example above again, consider a re-packaging charge of 50p per unit and a sales price of £6 per unit. While there is a vastly reduced sale price (£10 – £6) the comparison of NRV to historic cost is still paramount. In this situation the NRV is (£6 – £0.50 =) £5.50, which is higher than historic cost meaning that no adjustment is required.
2. Make sure inventories are not overstated. The valuation of inventories based on the lower of cost or NRV is an example of the prudence concept being applied. To present a 'fairer' picture of the enterprise it is essential that inventory values are correctly reviewed. PQ

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