Insights Unwrapped

Why Inventory Mishandling Hurts Shareholder Returns

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Significance of Physical Verification of Inventory

What is Inventory?

- *Tangible property held for sale, in production for sale, or for consumption in producing goods/services.*
- *Inventories also include stock of goods like raw materials including components, work-in-process, finished goods including by-products, maintenance supplies, stores and spare parts, and loose tools.*

Importance of Inventory?

- ***Asset Value:*** *Constitutes a significant portion of total assets, especially in manufacturing, trading, and some service entities*
- ***Financial Impact:*** *Affects cost of goods sold, profitability, and balance sheet accuracy*
- ***Audit Relevance:*** *Verification is critical to prevent misstatements, fraud, or losses, particularly in India where inventory is a key asset. Where third parties hold significant stocks of the entity, it becomes necessary that the auditor gets a written confirmation of the stocks held.*

Recent Red Flag at Ramkrishna Forgings Ltd (RKFL)

Inventory Discrepancy Disclosure – RKFL (April 26, 2025)

On April 26, 2025, RKFL announced that discrepancies were identified during the annual physical inventory verification for the financial year ended March 31, 2025. In response, the Audit Committee has engaged independent external agencies to conduct a joint fact-finding investigation to determine the root causes.

While the verification process is ongoing, the company's internal estimates suggest a **potential adverse impact of approximately 4% to 5% of its net worth.** Based on the findings of the joint report from the independent agencies, the company will recognize the financial impact on a one-time basis in its financial statements.
– Company Filings, BSE

Inventory Valuation Concerns for RKFL

- **RKFL's inventory** stood at INR 13.7 billion (as on H1 FY25), representing a significant **46.5% of its total net worth.** This underscores the critical importance of accurate inventory valuation to the integrity of the balance sheet.

- Notably, **finished goods in transit** amounted to INR 500 million in FY24, **comprising 28% of total finished goods.** Such inventory, being with third parties, poses challenges for physical verification.

- Auditors typically depend on physical verifications conducted by the company. **Discrepancies are not usually flagged unless they exceed a 10% threshold**, as seen in RKFL's audit report, which noted the verification process but raised no red flags.

This practice creates a potential blind spot. Discrepancies of 8–9%, while below the reporting threshold, could still be materially significant—especially for companies like RKFL, where inventory is a major balance sheet component.

Potential Inventory Risks in NSE-500 Companies

- Within the **NSE-500 universe, close to 10% of companies hold inventories equivalent to 40% of their net worth and 20% of their annual sales**—excluding sectors where inventory is not a material component.

- While these figures may not immediately trigger alarm, they point to a critical risk: i**n companies with large inventory holdings, even moderate valuation mismatches can materially erode shareholder value.** Such discrepancies often go unreported in audit findings due to high materiality thresholds, making them easy for investors to miss.

- Given these risks, there is a pressing need for both companies and auditors to adopt stricter standards for identifying and disclosing inventory-related issues. Investors, too, should be especially cautious**—closely monitoring not just inventory levels, but also movements, valuation methods, and the portion held with third parties.**

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When Inventory Goes Wrong: *Lessons from Past*

S. No.	Company Name*	Inventory/ Net Worth FY20	Inventory/ Net Worth FY21	Inventory/ Net Worth FY22	Inventory/ Net Worth FY23	Inventory/ Net Worth FY24	Impact of Inventory
1	Uniparts India Ltd.	76%	61%	64%	55%	49%	OPM^ has declined significantly—from 22% in FY22 to 16% currently —accompanied by a steep drop in stock price
2	Lux Industries Ltd.	67%	47%	64%	47%	41%	OPM has consistently fallen, dropping from 20–21% in FY21/22 to just 9% now
3	Meghmani Organics Ltd.	31%	32%	44%	39%	34%	Since FY20, OPM has deteriorated from 15% to operating losses or low single-digit margins, amid recurring fire incidents and insurance claims
4	Ramkrishna Forgings Ltd.	41%	50%	66%	69%	41%	Internal estimates indicate a potential impact of 4–5% on the company's net worth, reflecting substantial financial strain. Valuation multiples have already contracted.
5	Supriya Lifescience Ltd.	33%	27%	15%	17%	10%	On a positive note, inventory management has shown significant improvement over the past three years
6	Rupa & Company Ltd.	81%	54%	66%	53%	44%	OPM has sharply declined—from 20% in FY21 to 10% currently—underscoring the ongoing operational challenges

Source: ACE Equity; ^OPM: Operating Profit Margins; * no specific criteria for stock selection

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