

Valuation of High-end and Unusual Inventory

by Mark Kohn, CPA, CVA, CFE, ABV, CFF

In many businesses, one of the largest assets on the books is inventory. It is often a difficult asset to value properly, because the variety and volume, and sometimes the obsolescence, of the inventory make the valuation difficult. A further complication is that some inventories by their very nature should be valued by different methodologies, even if they are being valued using the same standard of value. This occurs in the valuation of high-end inventory such as expensive artwork, or in the valuation of unusual inventory such as a customized car.

In a valuation whose standard of value is fair market value, such as in a divorce setting, that is the standard of value to be used in the valuation of inventory, as all of the other assets.¹ That is not a simple concept, however.

If one owns a hardware store, the fair market value of all the hammers and nails is the value that another hardware store would pay for them, as nobody else would want a store full of hammers and nails. Therefore, the fair market value is really the cost. The buying hardware store would pay virtually the same price that the selling hardware store paid for those hammers and nails. There would be no reason to pay more than cost, because the buyer can just as easily, and maybe more easily, buy the same hammers and nails from the manufacturer at cost. Therefore, fair market value as applied to inventory is to be determined by looking at the probable buyers, and since the buyers of large quantities of hammers and nails would pay no more than cost, the fair market value of those items is, paradoxically, the cost that those items are charged by manufacturers or wholesalers.

Just as the fair market value is measured in most cases by cost, the method used to determine cost must reflect the fair market value. Therefore, if the business used a LIFO method to determine cost, one should adjust the inventory to a value that uses FIFO, because FIFO more accurately reflects the current costs on the marketplace and therefore more accurately reflects current fair market value. The objective is to determine the amount it would cost a potential buyer as of the valuation date to buy that inventory, which is what the FIFO valuation usually reflects. Similarly, in times of rapidly changing prices, or for items with volatile pricing such as certain commodities, one would look at the cost as of the valuation date rather than the date the inventory was actually purchased; but again, the costing would be at the price to buy from the manufacturer or wholesaler.

The above concepts apply to all inventories. However, applying the fair market value/cost concept to high-end and unusual inventories requires a modified type of analysis.

If an art dealer were in the middle of a divorce proceeding, and if his business owns just five pieces of art, each with a selling price of \$10 million, which he purchased at a cost of \$5 million each, it might be more appropriate to use the “take home” concept. The take home concept looks at what would happen if the business were closed and the owner took the inventory home with him. If the art dealer closes his business, and he takes those five pieces of art home and hangs them on the walls of his house, then most people would agree that one should hire an appraiser to value the personal art collection. (Note that the “inventory” whose *cost* on the books was \$5 million each has become a “personal art collection.”) What has happened is

¹Gary R. Trugman, *Understanding Business Valuation*, Third Edition, AICPA, 2008, Page 284; Shannon Pratt and Alina Niculita, *Valuing a Business*, Fifth Edition, McGraw Hill, 2008, Page 361; Revenue Procedure 77-12.

that inventory that cost \$25 million in total has moved from the business to the residence. At the residence, in divorce cases, the standard to use is fair market value using an appraised value. An appraiser is asked to value the residence; the family cars are valued at their current fair market value, and all other personal assets are valued at their appraised value. How would the appraiser determine the fair market value of the five pieces of art? The same way it is usually done: by looking at comparable sales, not at the actual cost paid to acquire the personal assets. If the residence cost \$250,000 many years ago and today it is worth \$1 million, the value that is used is \$1 million. Using the same principle, the art collection that is now in the residence would be valued at \$10 million each, for a total value of \$50 million. This should be true *even if the art never moved from the business location*. It would be illogical to argue that if the art is located downtown in the business district the valuation would be \$25 million in total, while if the same art were moved a few miles away to the residential district the value would be \$50 million.

Therefore, for low-end inventory, the methodology to use is the cost to buy from the manufacturer; while for high-end inventory, the methodology to use is current appraisal (or some other similar method that is as close as possible to fair market value) that ignores the location of the items.

Thus we have two extremes: (a) hammers and nails and (b) very expensive artwork. In between those extremes are the difficult areas. Consider an art dealer with 1,000 pieces of art that cost \$10,000 each; and then consider an art dealer with 100 pieces of art that cost \$100,000 each. One can intuitively see that the smaller the cost per item, the more one would use the purchase cost as the value; and as the cost per item goes up, the more likely that the appraisal value would determine its value. There is a continuum that goes from purchase cost to appraisal value, and the business appraiser might have to consider each type of inventory based on its characteristics. It might even be necessary to value some of the inventory at the purchase cost, some at appraisal value, and some using some sort of midpoint. The high-end art would be valued at appraisal value while the lower-level art might be valued at cost or somewhere between cost and appraisal value. This "somewhere" is to be determined using the best judgment of the business valuator. Business valuation is described as an art, not a science, and that is certainly true when valuing art and unusual inventory.

Continuum Analysis

One will encounter these inventory issues in a variety of businesses. One example of the need for appraisals and possibly a continuum would be in the valuation of a high-end musical instrument business. The inventory might include a few Stradivarius violins, each worth between \$250,000 and \$500,000; a few less famous violins worth \$100,000 each; a selection of violins that sell in the \$25,000 range; and a large selection of fine-quality violins that sell for \$2,500 to \$10,000. Other examples of the above concept would be the valuation

of a business that sells antique furniture or classic cars, with a mix of high-end, middle, and low-end inventory.

The special chair sat in by Louis XIV would most likely not change value if its location changed from a downtown store to someone's living room, and that value would be its appraisal value, not its cost. Some of the other pieces of furniture might be far lower in prestige, and others may be entry-level antiques. A rare car would have the same value if it sat in a downtown rare car store, or in a residential garage. The fact that it is "inventory" does not lower its value to purchase cost. The rare car would be valued at appraisal value, while the less rare cars might be valued at cost or somewhere between cost and appraisal value.

Other examples would be the inventory of a company that makes customized yachts, the inventory of a famous sculptor, and perhaps even the inventory of customized electronics. The same would apply to the inventory of a jeweler who sells very high-end jewelry. The value of a million-dollar necklace should not change if it goes from the designer's showroom to adorning a lady's neck. If that designer has a variety of jewelry ranging from high end to lower end, the inventory might have to be valued using a continuum. The same might be true for a diamond dealer whose inventory consists of large, exquisite, rare diamonds. Once a valuator is aware of these concepts, one will see these issues appear more frequently than one would otherwise expect.

Exotic Inventory

Unfinished, exotic inventories fit into the continuum concept as well. Consider a car customizer with 10 cars in progress that will be sold for \$500,000 each. He purchased 10 new vehicles, some of which he cut in half to make stretch vehicles and others that are being bulletproofed along with other customization. In their present condition, the 10 vehicles are useless. In a divorce proceeding, it would not be surprising to hear the business owner argue that the inventory is worth the same as scrap metal, while the opposing spouse argues they are worth close to \$500,000 each. While not definitive, Revenue Procedure 77-12 suggests a possible third conclusion based on the expected sales price to a specific customer, less the cost to finish the inventory and less the cost of selling the inventory.

Another example of exotic inventory is that of a prestigious breeder of thoroughbred horses. He would have young horses in his inventory, as well as more mature horses, and he might have pregnant horses with great lineage. Similarly, a famous artist may be in the middle of one or more paintings that might sell for \$20 million when they are completed, but at present the artwork is incomplete and unsalable. One probably would not value the younger horses or the half-finished painting at cost, knowing the potential that lies in that inventory. Instead, informed judgment would have to be used, and the final value

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Letters to the Editor

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A. Frank Adams, III, responds:

In his comment on my article, “When a ‘Simple’ Analysis Won’t Do: Applying Economic Principles in a Lost Profits Case,” Mark Filler criticizes the model and procedure I suggested to estimate lost revenue to a particular motel in a lost profits case.

His criticism is primarily on statistical grounds, and he offers a time-series-based procedure that he believes to be preferable. As I will show in my rejoinder, his statistical criticisms of my original model are without substance; many are simply wrong.

Mr. Filler also mischaracterizes the fact pattern presented in my original article. Contrary to his claim, the only statistically significant downward trend in occupancy rates occurred for the damaged motel during the entire sample period, not during the 16-month pre-period of interruption. Thus, whatever was causing the downward trend in motel occupancy,

those effects were confined to the damaged motel and were captured in my original model.

Finally, Mr. Filler would have you believe that my estimate of expected sales for the damaged motel during the period of interruption is “an apparent anomaly.” He provides no basis for this claim, as he fails to provide total market revenues during the period of interruption or for the same period in the prior year. I have that data but Mr. Filler did not ask me for it. In fact, he never asked me for any additional data or information regarding this “market.” I will, however, provide that data in Part 2 of my rejoinder that will hopefully be published in a future issue of *The Value Examiner*. Part 2 will be much more “reader friendly” than Part 1, as it will focus less on econometric technique and more on what a damages expert would present to a trier of fact. In the meantime, I hope you enjoy our debate. **VE**

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would probably be much closer to the value that would exist upon maturity and completion—somewhere between the cost and the ultimate value at maturity or completion.

Unusual Circumstances

Finally, there is the situation where someone in business has made an unusually good purchase of a significant quantity. As an example, a piano dealer is able to buy a truckload of pianos at 50 percent of the normal manufacturer’s cost, because he bought them from another dealer that was going out of business. Assume the truckload could be purchased from the manufacturer for \$500,000, the retail selling price would be \$1 million, and this person managed to buy the truckload for \$250,000. I think most professionals would value the inventory at a value of at least \$500,000. While you might think that you should apply the concept of lower of cost or market, which is often used for income tax purposes, that concept applies when the cost in the marketplace has dropped. In our hypothetical example, the cost in the marketplace has not dropped. Instead, the business owner simply made an unusual purchase that bypassed the normal marketplace. Therefore, if the “truckload” consisted of only four extremely high-quality concert grand pianos, then the take-home/appraisal standard of value would probably apply, and the value would be \$1 million. If the truckload consisted of many cheap pianos, the value would presum-

ably be \$500,000, which is the cost to buy them from the manufacturer. If the truckload consisted of 10 pianos, all of very high quality but not extremely high quality, one has to decide where on the continuum one should be, using one’s judgment.

No Rigid Formulas

Revenue Procedure 77-12 deals with the valuation of inventory, and while it provides guidelines, it does not provide rigid rules. In fact, the conclusion states that “no rigid formulas can be applied.” Different inventories require different methodologies, especially when the inventory is unusual.

In summary, the value of high-end and unusual inventory is often one that requires thoughtful analysis. While ordinary inventory is usually valued at cost, using relatively simple financial analysis, high-end and unusual inventory would have to be valued at appraisal value or somewhere between cost and appraisal value, using a more thoughtful analysis combined with good judgment. **VE**



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