

Inventory Definitions & Explanations of Value

REPRODUCTION COST, NEW and **REPLACEMENT COST, NEW** are concepts that are rarely used for an inventory appraisal, but could be applied if so requested by the client and requires no real revision to the standard definitions, since they are sufficiently broad to encompass any application to the appropriate inventory.

One example where these concepts of value may be applied to inventory would be a machinery re-builder who maintains an inventory of rare printed circuit boards (PCB's) for obsolete Numeric Controls. Although seldom called upon to draw from this inventory, its market value would be relatively low. On the other hand, its Reproduction Cost, New would be extremely high because these PCB's have been out of production for over a decade. In this case, the inventory's Replacement Cost, New would also be low, because the same utility with new technology can be produced for a fraction of what these circuit boards originally cost.

FAIR MARKET VALUE – IN CONTINUED USE is modified for inventory to be “the estimated gross amount, expressed in terms of money, that a willing buyer would be justified in paying for the inventory in-place and in-use, and a willing seller would be warranted in accepting if each is: 1) not under any compulsion to buy or sell; 2) well informed or well advised of all relevant facts; 3) motivated by reactions of typical users; 4) free of undue stimuli; 5) financially capable of ownership, and/or use; and 6) allowed a reasonable length of time to test the market. It is further assumed that the earnings will support a continuation of the product line”.

The estimate of today's cost to the original buyer, and under that buyer's pricing structure, is the basis for this value application. It discounts for depreciation and obsolescence, if any, and deducts for inventory found lacking in utility. Additional consideration is also given, where applicable, to the contribution of the inventory to the overall business.

FAIR MARKET VALUE - REMOVAL is modified for inventory to be “the estimated gross amount, expressed in terms of money, that a willing buyer would be justified in paying for the inventory, and a willing seller would be warranted in accepting if each is: 1) not under any compulsion to buy or sell; 2) well informed or well advised of all relevant facts; 3) motivated by reactions of typical users; 4) free of undue stimuli; and 5) allowed a reasonable length of time to test the market”.

This definition for inventory can consider a bulk sale under the conditions described, but should not be interpreted as a "going concern" concept. Under this definition, work-in-process inventory is not presumed to be completed by the buyer. The question is “Is the inventory being valued fully burdened through the effective date of the appraisal?” In other words, despite the progress toward completion, the work-in-process value will include any labor expense or overhead allocated to that item using generally accepted accounting principles. Under this concept, the work-in-process would be valued either as scrap or as if complete.

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The machinery & equipment concept of **Liquidation Value - In Continued Use** has been essentially replaced by two concepts of value intended for inventory valuations only, both which consider some departure from the traditional interpretation of **Orderly Liquidation Value**. These concepts are respectively **Orderly Liquidation Value through Continued Operation**, and **Liquidation Value through Continued Use**.

ORDERLY LIQUIDATION VALUE THROUGH CONTINUED OPERATION is “the estimated gross amount, expressed in terms of money, projected to be obtainable over a finite period, for a finished goods inventory sold under the direction of a secured party”.

The express intent of sale in this manner is liquidation into the next highest level of trade, through continued operation of the entity, with the secured party responsible for all operating expenses, and the beneficiary of all sale proceeds.

This concept of value is intended to be applied in circumstances where the presumed overnight disappearance of a subject entity has been deemed unlikely. These circumstances can include an inventory that is so large in composition, or so dispersed regarding location, that the market into which it would be tendered has an insufficient capacity to absorb all items within the limited time frame. This can occur in situations with large overall market shares or geographic domination of a particular market. Other circumstances can include situations where there is a captive customer base in the sense that a transition period would be required, during which the customer would locate a suitable replacement. This factor tends to occur in situations where the inventory mix is relatively complex, and would require several different sources to maintain mix continuity. This can also occur when the subject is the single source of supply.

Generally, the method of valuation under this definition is to segregate the inventory for sale into both levels of trade under consideration. Therefore, the liquidation-marketing period is divided into two distinct groups. For the first liquidation period, the inventory would continue to be sold to the existing customer base, and would be valued at some expression of the current sales price. The second liquidation period would begin immediately thereafter, and sale to the customer base would then be suspended. All remaining inventory would be sold to purchasers at the same level of trade as the subject, and the subsequent recovery would be expressed as a percentage of cost. The weighted-average of recovery for both periods would be the final expression of value.

LIQUIDATION VALUE THROUGH CONTINUED USE is “the estimated gross amount, expressed in terms of money, projected to be obtainable over a finite period, for a manufacturer’s inventory sold under the direction of a secured party”.

Though the language in this concept is very similar to the “Continued Operation” definition, the express intent of sale in this manner, and the primary difference between the two concepts, is completion of some

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elements of the work-in-process inventories into finished goods, through continued operation of the entity, with the secured party responsible for all operating expenses, and the beneficiary of all sale proceeds. The reason the word “some” is to allow the appraiser(s) maximum flexibility in determining which elements of the work-in-process inventories justify completion; the test of which rests upon a cost/benefit analysis. As part of this analysis, the raw materials would be separated into that which would be required in the completion process and that which would be liquidated as is.

As an example of appraising inventory under this concept of value, consider a manufacturer of steel. Such a manufacturer may make steel through any number of processes, from coke distillation to the melting of scrap. In addition, there are often a large number of alloy materials; even such items as supplies must be taken into account. Assuming the appraiser(s) have identified the number of pre-existing orders that can be filled in which maximum recovery would be far above the liquidation percentage of recovery for the raw materials, the next step would be to identify which raw materials and what quantities of each would be required. In addition, in this scenario as described, to maximize recovery, a secured party may, in fact, have to purchase some raw materials to keep the inventory in balance as the liquidation goes forward, which would be in addition to the actual work-in-process because, in this case, a conversion of some raw materials would be part of the typical liquidation process.

FORCED LIQUIDATION VALUE is “the estimated gross amount, expressed in terms of money, that could be typically realized from a properly advertised and conducted public auction sale, negotiated liquidation sale, or a combination of the two, with the seller being compelled to sell with a sense of immediacy, on an as-is, where-is basis, under present-day economic trends”.

The key component to the Forced Liquidation scenario, as it applies to inventory, is the word “public”, as opposed to auction. This is because inventory is generally only sold at auction as a last resort or as a means to increase a sale’s draw, and the word “public” is typically interpreted to mean, “generally known”. This would be especially true in the case of a liquidation sale of a proprietary product line in which the only interest would be from competitors or, possibly, other investors. Therefore, the exposure to the “public” is realistically limited to only those interested parties, as opposed to the general public. The term public also implies a competitive bidding process, at the end of which a determination would be made as to which bids are to be accepted, and though the sale may technically be categorized as an auction, the sale of inventory is often sold utilizing the sealed bid process far in advance of an actual auction.

SALVAGE VALUE, while theoretically applicable, is seldom requested or utilized in the appraisal of inventory. However, Scrap Value is often requested, especially when valuing work-in-process inventory under one of the liquidation scenarios. This is because asset-based lenders typically exempt work-in-process from a borrower’s collateral base or, as an alternative, an appraiser is called upon to assess what, if any, value could be found in the material component of the work-in-process.

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