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COORDINATED ISSUE
RETAIL INDUSTRY
VALUATION OF AN ACQUIRED RETAILER'S INVENTORY

Facts

Company X purchased all of the assets of a business, including inventory items, for a lump sum. The business was a going concern that Company X continued to operate as a chain of general merchandise retail stores. The purchase price was allocated among the assets acquired to determine the basis of each of such assets. In making such determinations, it was necessary to determine the fair market value of the inventory items involved.

Company X used the comparative sales method (also referred to as the net realizable value method) to determine the fair market value of the acquired inventory. In its computations, Company X used the expected selling price of the goods in the inventory, less only direct disposition costs. All other disposal costs were disregarded.

Questions

Is the cost of reproduction method more appropriate than the comparative sales method in determining the fair market value of a retailer's inventory?

When the comparative sales method is used as a basis for valuing a retailer's inventory, what costs should be considered as inventory disposition costs?

Regulation 1.471-4

Treasury Regulation 1.471-4 deals with the fair market value of inventory and provides as follows:

> Inventories at cost or market, whichever is lower.
> (a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases - (1) of goods purchased and on hand,
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> (b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair

> market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory.

Revenue Procedure 77-12

Rev. Proc. 77-12, 1977-1 C.B. 569 provides guidelines for use by taxpayers and Service personnel in valuing inventory where the inventory has been purchased in bulk.

The revenue procedure describes three methods that an appraiser may use to determine the fair market value of inventory: the cost of reproduction method, the comparative sales method and the income method.

Discussion

The cost of reproduction method provides guidelines for valuing inventories which can be readily replaced in a wholesale or retail business. This method values inventories at replacement cost, i.e., what it would cost to assemble identical inventories under prevailing market conditions.

The cost of reproduction method is the preferred method to use when valuing retailers' inventories because it is generally less susceptible to error than the comparative sales method. During the normal course of a retailer's business, there are fewer expenses involved in acquiring an inventory of goods than in disposing of the goods, particularly in department, discount, grocery and specialty stores. Retailers are in the business of selling goods; the majority of their efforts (and costs) relate to the sale of inventories. The cost of reproduction method, when accurately computed, does not include elements of going concern. It only includes the costs to assemble the inventories.

The direct costs of reproducing inventories in the retail industry generally include the vendor costs plus freight, import duties, etc., and direct labor relating to the acquisition of inventory. Direct labor includes the purchasing, receiving and handling salaries involved in placing the goods on the shelf.

The indirect costs of reproducing inventories in the retail industry generally include costs that relate directly to purchasing, off-site storage and handling. These include depreciation, repairs, utilities, etc.

The comparative sales method utilizes the actual or expected selling prices of finished goods to customers as a basis for determining fair market values of those finished goods. When the expected selling price is used as a basis for valuing finished goods inventory, consideration should be given to the time that would be required to dispose of this inventory, the direct and indirect expenses that would be expected to be incurred in such disposition, the part of the selling price that is attributable to going concern (trademarks, trade names, location, etc.) and a profit commensurate with the amount of investment and degree of risk.

The comparative sales method may be less susceptible to error when valuing manufacturers' inventories because manufacturers generally have few costs of disposition of their inventories, when compared to the costs incurred to produce their inventories and therefore have fewer costs that enter into the computation of the comparative sales method. They are in the business of manufacturing, the majority of their efforts and costs relate to the manufacturing process (the acquisition of inventories).

Some of the direct and indirect expenses that are incurred in disposing of a retailer's inventory during the normal course of business are:

1) Selling and support service expenses, e.g. direct selling, supervision, customer services, wrapping and delivery.

2) Sales promotion expenses, e.g. advertising, exhibits and sales supervision.

3) Credit and accounts receivable expenses, e.g. collection, credit management, cash office and branch/store selling location offices.

4) Selling related property and equipment expenses, e.g. depreciation, insurance, rent and taxes.

5) Selling related management costs, e.g. executive office, branch management, internal audit, legal and consumer activities.

6) Selling related accounting and management information costs, e.g. control management, general accounting, sales audit, payroll and data processing.

7) Selling related service and operations costs, e.g. service and operations management, security, telephone, utilities, maintenance and repairs.

8) Selling related personnel costs, e.g. personnel management, employment, training, medical and other employee services and supplementary benefits.

9) Other costs, e.g. research and experimental, shrinkage, employee discounts and mark-downs.

There may be additional expenses to be deleted from the selling price in the comparative sales method; the above expenses are only provided as examples.

Not mentioned in describing the methods above is the contention that additional value attaches to a well balanced inventory. Additional value is said to arise because the inventory contains few overstocked or obsolete goods that have to be disposed of at deep discounted prices, is displayed in an attractive manner promoting prompt sale, is ready to meet the demands of customers in the ordinary course of business, or has some other claimed advantage. Yet the fair market value of the inventory contemplates valuing only the items (goods) themselves. Imagine, therefore, valuing the inventory without the advantages of the merchandiser's location, trademarks, trade names, window displays, trained sales staff, etc. These advantages, permitting inventory to be placed instantly on the market, are but elements of going concern value, not inventory value. Hence, when elements of going concern value are removed, as they must be to determine the value of the inventory, the remainder should reflect only the value of the inventory calculated under one of the methods. Generally, then, the value of a well balanced inventory is determined by correctly applying the valuation method, not by adding to the value determined under the method.

Correctly applied, the cost of reproduction method and the comparative sales method should arrive at the same value.

Conclusion

When valuing retailers' inventories, the cost of reproduction method is less susceptible to error and therefore more appropriate to use than the comparative sales method.

If a taxpayer uses the "comparative sales" or "net realizable value" method, all expenses attributable to the disposition of the acquired inventory must be included in the taxpayer's computation, not just direct disposition costs. Consideration must also be given to the time that would be required to dispose of the inventory, the part of the expected selling price that is attributable to going concern and to a profit that is commensurate with the amount of investment and degree of risk.

In making the inventory value determination, the Service will take into account a fair division of the inventory profit between the seller and buyer of the bulk inventory.