INVENTORY VALUATION METHODS

The method a small business chooses for inventory valuation can also lead to substantial tax savings. Inventory valuation is important because businesses are required to reduce the amount they deduct for inventory purchases over the course of a year by the amount remaining in inventory at the end of the year. For example, a business that purchased $10,000 in inventory during the year but had $6,000 remaining in inventory at the end of the year could only count $4,000 as an expense for inventory purchases, even though the actual cash outlay was much larger. Valuing the remaining inventory differently could increase the amount deducted from income and thus reduce the amount of tax owed by the business.

The tax law provides two possible methods for inventory valuation: the first-in, first-out method (FIFO); and the last-in, first-out method (LIFO). As the names suggest, these inventory methods differ in the assumption they make about the way items are sold from inventory. FIFO assumes that the items purchased the earliest are the first to be removed from inventory, while LIFO assumes that the items purchased most recently are the first to be removed from inventory. In this way, FIFO values the remaining inventory at the most current cost, while LIFO values the remaining inventory at the earliest cost paid that year.

LIFO is generally the preferred inventory valuation method during times of rising costs. It places a lower value on the remaining inventory and a higher value on the cost of goods sold, thus reducing income and taxes. On the other hand, FIFO is generally preferred during periods of deflation or in industries where inventory can tend to lose its value rapidly, such as high technology. Companies are allowed to file Form 970 and switch from FIFO to LIFO at any time to take advantage of tax savings. However, they must then either wait ten years or get permission from the IRS to switch back to FIFO.

INVENTORY

There are three basis approaches to valuing inventory that are allowed by GAAP:

(a) First-in, First-out (FIFO): Under FIFO, the cost of goods sold is based upon the cost of material bought earliest in the period, while the cost of inventory is based upon the cost of material bought later in the year. This results in inventory being valued close to current replacement cost. During periods of inflation, the use of FIFO will result in the lowest estimate of cost of goods sold among the three approaches, and the highest net income.

(b) Last-in, First-out (LIFO): Under LIFO, the cost of goods sold is based upon the cost of material bought towards the end of the period, resulting in costs that closely approximate current costs. The inventory, however, is valued on the basis of the cost of materials bought earlier in the year. During periods of inflation, the use of LIFO will result in the highest estimate of cost of goods sold among the three approaches, and the lowest net income.

(c) Weighted Average: Under the weighted average approach, both inventory and the cost of goods sold are based upon the average cost of all units bought during the period. When inventory turns over rapidly this approach will more closely resemble FIFO than LIFO.

Firms often adopt the LIFO approach for the tax benefits during periods of high inflation, and studies indicate that firms with the following characteristics are more likely to adopt LIFO - rising prices for raw materials and labor, more variable inventory growth, an absence of other tax loss carry forwards, and large size. When firms switch from FIFO to LIFO in valuing inventory, there is likely to be a drop in net income and a concurrent increase in cash flows (because of the tax savings). The reverse will apply when firms switch from LIFO to FIFO.

Given the income and cash flow effects of inventory valuation methods, it is often difficult to compare firms that use different methods. There is, however, one way of adjusting for these differences. Firms that choose to use the LIFO approach to value inventories have to specify in a footnote the difference in inventory valuation between FIFO and LIFO, and this difference is termed the LIFO reserve. This can be used to adjust the beginning and ending inventories, and consequently the cost of goods sold, and to restate income based upon FIFO valuation.