



Is LIFO Right For Your Company?

As long as inflation has been generally at bay, few manufacturers or distributors have paid much attention to the last-in, first-out method of inventory valuation known as LIFO.

But for more companies that face rising prices, LIFO deserves consideration as a valuable tax management tool.

Under LIFO, the last inventory purchased is treated as the first sold. The method permits the balance sheet to show year-end inventory valued at earlier, lower prices, regardless of when the inventory moved.

When Prices Go Up

As an example, consider a company that buys ten castings in January and six more in December, for a total of sixteen. It pays \$50 each for the first set and \$80 each for the second. During the year the company sells eight of the castings.

If the company uses the more common FIFO (first-in, first-out) valuation method, its income statement shows cost of goods sold as \$400 (the eight parts sold cost \$50 each). Its year-end inventory is valued at \$580 (the eight remaining parts include two bought at \$50 and six bought at \$80).

A LIFO calculation reverses these results. Using LIFO, the cost of goods sold is \$580 (six \$80 parts and two \$50 parts). The eight parts that remain in inventory at year-end are valued at \$400 (eight parts at \$50).

LIFO is tailor-made for automotive dealerships, whose suppliers raise prices every year like clockwork.

The LIFO method results in lower inventory values and higher values for

cost of goods sold. When a company faces rising prices, that results in a lower income tax bill.

Easy to Try Out — Once

It's easy to move to LIFO, and if things don't work out, it's easy to retreat — with one big catch. A company that leaves LIFO can't return to it for five years without IRS permission, and that's rarely granted. So make an informed decision by performing accurate cost forecasts.

LIFO can give comptrollers headaches. Tracking costs in various pools of inventory — raw material, work-in-progress and others — is tedious, particularly for larger companies. Matters grow more complex when inflation affects some items but not others, resulting in uneven LIFO benefits.

The IRS also requires that the same valuation method be used on financial statements, where the lower-net-income result of a LIFO calculation may be less attractive to lenders. But companies are permitted to footnote their statements with net income calculated from a non-LIFO method, which may provide a healthier picture.

Complexity Reduced

In times of low inflation, these drawbacks have historically outweighed the benefit of switching to LIFO for many firms, since the potential lessening of the tax burden that LIFO offers is small or nonexistent.

But simplified LIFO computation rules have made the method much more attractive. Several years ago, the IRS began allowing companies to calculate inflation or deflation in various inventory categories by reference to standard indices published by the Bureau of Labor Statistics.

This relieves LIFO users of some administrative burdens and also makes more accurate forecasting possible. As with the standardized deduction on a 1040, this provision may not save as much as more detailed analysis.

The LIFO election is taken on IRS Form 970 and is available as late as the extended due date for returns.

Is LIFO for you? Our firm can help you gain a line of sight to the bottom line.