LIFO vs. FIFO: Choosing the Right Inventory Valuation Method

Arthur F. Rothberg, Managing Director, CFO Edge, LLC

It's critical that manufacturers, wholesalers and retailers know how to manage inventory. If you're a manufacturer, your inventory is raw materials, work-in-progress and finished goods, and if you're a wholesaler or retailer, your inventory is only finished goods.

Your inventory is probably a significant component of your balance sheet. Therefore, you should understand the ins and outs of solid inventory management. This includes proper accounting for inventory costs, as well as the nuances involved in using Last-In, First-Out (or LIFO) and First-In, First-Out (or FIFO) accounting.

Understanding LIFO & FIFO

With LIFO accounting, it's assumed that the last inventory items in will be the first inventory items sold or used. With FIFO accounting, it's assumed that the first inventory items in will be sold or used first. Practically speaking, FIFO more closely represents the actual physical movement of goods, since most companies use the oldest items in inventory first to help prevent deterioration and obsolescence.

So, if a widget company restocked its inventory of May, August and November, LIFO would assume that the widgets inventoried in November would be sold or used first. Conversely, FIFO would assume that widgets inventoried in May would be sold or used first.

So why does this distinction matter? The most important reason is that the inventory valuation method used will significantly impact the inventory's value and cost of goods sold. FIFO, for example, values inventory at close to replacement cost, while LIFO values inventory at less than it would cost to replace it. This means that LIFO usually reduces net income and, as a result, current income taxes.

For example, let's say that a company places ten widgets in inventory in January and six more in December. It paid $500 per widget in January, but the price rose to $800 per widget by December. The company sold eight widgets during the year. FIFO would calculate the cost of goods sold (COGS) as $4,000 (eight widgets sold x $500 each) for a year-end inventory valuation of $5,800 (two bought at $500 each plus six bought at $800 each).

But if the company uses LIFO, the COGS would be $5,800 (six $800 widgets plus two $500 widgets) and the year-end inventory valuation would be $4,000 ($500 each for the eight remaining widgets), or $1,800 less than if it used FIFO. If the company pays a corporate tax rate of 35 percent, this lower year-end inventory value would reduce its tax bill by $630.

The LIFO Reserve

The tax benefits of LIFO accumulate from year to year, resulting in what's known as a LIFO reserve — or the difference between LIFO and FIFO calculations. This LIFO reserve can add up over time, resulting in even more tax benefits. Note that the LIFO reserve must be recorded in your records and you also must perform annual LIFO valuations.

Generally, the potential tax benefits of using LIFO are usually greater when prices are rising. This means that LIFO usually is not as beneficial during a low-inflation environment like we have experienced in recent years. So, one determinant in whether to use LIFO or FIFO is whether the prices of your inventory are rising, falling or remaining steady.

Also, if LIFO is used for income tax purposes, you also must use LIFO for financial statement reporting purposes. This will lower your reported net income, which could make it harder to borrow money or obtain financing and make your company less attractive to potential buyers. Be sure to take this factor into consideration if you plan to seek financing or sell your business in the relatively near-term future.

To switch from the FIFO to the LIFO inventory valuation method, you will file IRS form 970 along with your federal income tax return. You have until the extended due date of your tax return to make the switch for the current tax year, and you can switch back to FIFO later if you want. But if you do, you can't reelect LIFO for another five years. Therefore, make sure you're reasonably certain before making the switch to LIFO.

Concluding Thoughts

Your inventory probably accounts for a significant amount of money on your balance sheet, so it's critical that you understand the basics of sound inventory management. This includes understanding the nuances involved in using LIFO and FIFO accounting. In the right circumstances, using LIFO accounting can result in tax savings for your business. An outsourced CFO services provider can help you weigh the pros and cons of using LIFO and FIFO accounting to make the right decision for your company.

About CFO Edge

CFO Edge, LLC delivers enterprise-class financial and operational performance solutions to executives throughout Southern California. Based in Los Angeles, our formerly-seated chief financial officers engage on demand as part-time CFOs, single-project CFOs, and interim CFOs to help business leaders successfully resolve pressing challenges and realize their financial and operational goals. At CFO Edge, we are passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 800.276.1750 Ext 101.