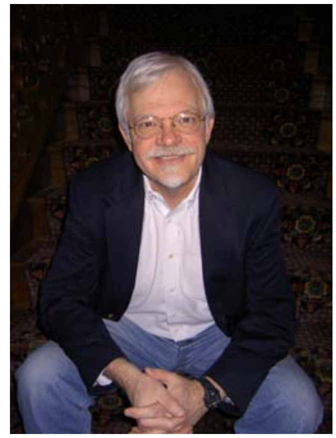
The River Heights View

River Heights Consulting

The LIFO Crisis: A Four Minute Overview
Frank Hurtte and Jim Schmitt

As the US Senate searches for a way to raise taxes on Big Oil, the political pundits poise to attack the time-honored (since the 1930's) LIFO inventory accounting practice. LIFO hit the political radar screen as a vehicle to pay for a measure to provide Middle America with a tank and a half of gas ($100). "$4.3 Billion in new Federal Taxes from the largest five oil companies" makes great election year headlines. And, this measure refuses to die as the Senate Finance Committee (led by Senator Charles Grassley of Iowa) considers whether to hold hearings on the repeal of LIFO. The sad truth is most Americans do not understand the intricacies of business, nor do they understand the Tsunami wave of cash flow issues that could be unleashed. This is not about Big Oil; this is about the tens of thousand of businesses that form the backbone of the Americana Economy.



Frank Hurtte of River Heights Consulting combines "in the trenches" experience with long range strategic thinking.

<u>What is LIFO? Last In – First Out</u>

If you are like many distributors, you are familiar with the term LIFO. Inventory discussions revolve around this term and others like it. During conversations with your accountant or banker, they ask about your inventory method – when you reply LIFO - everybody nods and the conversation continues on. The next four minutes will equip you to think past the familiar term and into the long term ramifications.

The three most common methods of inventory evaluation for distributors are:

- Average Cost
- FIFO – first-in, first-out
- LIFO – last-in, first-out

In <u>Average Cost</u>, the cost of all units is averaged together and the result is used to measure the value of the entire inventory.

<u>FIFO</u> (first-in, first-out) assumes the first units purchased are the first units sold and inventory consists of the most recently purchased units. In FIFO the inventory value is based upon current prices, but the costs of goods sold are measured at the older and in most instances lower cost. This results in a higher amount of reported income.

<u>LIFO</u> (last-in, first-out) assumes the inventory most recently purchased is sold first. This method couples cost of goods sold with the most current costs. When prices are increasing year after year, LIFO typically shows a more accurate picture of profits by eliminating the "paper profits" of unsold inventory. The offset of this is that oldest purchase prices are used in valuing the inventory. This creates a phenomenon where the inventory value is undervalued compared to its real world replacement cost.

<u>So what's the deal with LIFO?</u>

LIFO has become the preferred method for inventory valuation because it allows a company to build cash reserves. The amount of income that is deferred is called the LIFO Reserve. LIFO Reserve builds up each year that prices of inventory go up. Each year inflation data is logged by www.inflationdata.com. Generally speaking, a $1.00 item in 1982 would cost $2.01 in today's dollars. For most companies the historical trend has always been in the upward direction. In most recent years, steel, cooper, plastics and other commodities have further pressured this upward trend (in double digits amounts).

The Specialist Question

- What is a specialist?
- Who is using them?
- Who are these specialists?
- What are the pitfalls related to Product Specialists?
- What have the results been?

The LIFO Crisis

How does this affect your business? Let's assume a modest sized business with sales of $10 Million with a gross profit percentage of 25% and inventory turns of 5.

Sales	$10,000,000
Cost of Goods Sold	$7,500,000
Inventory turns	5
Inventory Value	$1,500,000
Upward direction of prices in 2005	3%
Addition to LIFO Reserve	$45,000

If the prices of items in stock were to go up by just 3% and the company used FIFO rather than LIFO, this would equate to $45,000 dollars of additional (yet to be earned) income being reported. If the Company uses LIFO to value inventory, $45,000 would be added to the already existing LIFO Reserve. This properly measures the income picture by not showing income that might happen when the inventory is finally sold off. Businesses using LIFO during times of upward directing prices experience a temporary tax deferment.

Are there pitfalls of LIFO?

The number one pitfall comes if unit prices were to take a downward direction. An example by be the automotive industry. Dealerships faced a downward price adjustment in late 2005 which impacted their income and LIFO reserves. (August 2005 Plante Moran Auto Dealer Alert)

What would happen if LIFO regulations were changed?

If LIFO regulations are changed, many businesses with extensive inventory will find themselves with tax bills. The LIFO Reserve of businesses (like our sample business above) who have used LIFO for 20-30 years could easily be greater than a half million dollars. This essentially becomes taxable income. And, though the initial discussion in Washington to repeal LIFO suggested a 20 year amortization of taxes due on LIFO reserves, new legislation could be much less patient. A LIFO reserve of $500,000 and a corporate tax rate of 39.3%. (http://www.taxfoundation.org/blog/show/1471.html) equates to this (modestly sized) business owing $196, 500 in additional tax.

According to a recent survey of the 595 U.S.-based members of Heating Air-conditioning and Refrigeration Distributors International (HARDI), nearly 50% of the Distributor members and 40% of the Manufacturer/Supplier members used LIFO with a "landslide" majority of members over $50 Million in size using LIFO because products in the HVACR industry are generally high-value products made from extremely inflationary raw materials such as steel, copper, and petroleum. This is a real issue and certainly one that demands your attention as a business manager.

Let River Heights Consulting assist you on with your strategic business issues.

River Heights Consulting: The Story behind the Story.

River Heights Consulting was founded by Frank Hurtte to address the needs of the distribution channel. Frank Hurtte, RHC Founder, is fond of saying, "In sports, everybody wants to practice running, but in the game, it's the hand-off that makes the difference." Whether the hand-off is between distributors and their suppliers, distributors and their customers, or between multiple distributors, River Heights can help. To receive complimentary issues of "The River Heights View" please send an email to; info@riverheightsconsulting.com Frank and his staff would like to hear from you.

"Think like a man of action, act like a man of thought…"

Heneri-Louis Bergson

The LIFO Crisis (cont)

What if my business does not use LIFO?

If you do not use LIFO - this uncalled for change in accounting procedures may still affect your business. The widespread use of LIFO would imply that one of your customers or suppliers probably does use LIFO. If you are a manufacturer, this could equate to your distributors driving down their inventory levels. As a potential user of inventory this could mean longer down time as parts are shipped in from remote areas. Retailers may drive down inventory levels and those who do not will need to charge more to support the tax burden on yet to actually be realized inventory.

There are only a few issues each year that require the attention of the business world. This is one of them. Now is the time of business leaders to step up and help educate their Congressional leaders.

Meet the authors...

Frank Hurtte (frankehurtte@riverheightsconsulting.com) is a consultant to distribution and the sales channel at River Heights Consulting. He has 28 years of real world experience and is available as a speaker and executive coach. He has written a number of articles and white papers on distribution and the selling process. Frank has helped a number of businesses and not-for-profit corporations through the strategic planning process. You can contact Frank at 563-514-1104 or through www.riverheightsconsulting.com.

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To ensure a win-win outcome, ERA works on a success-fee basis. Our Intelligent Cost Reduction Services cut our clients' costs by an average of 21%. We are committed to making your business more profitable by ensuring every dollar you spend is a dollar well spent.