

Abstract: An improperly or inadequately managed inventory system can drag down a company's revenues. For this reason, it's a good idea to regularly review inventory accounting and management to ensure best results. This article describes the two primary inventory accounting methods for both tax accounting and financial accounting.

Reviewing your company's inventory options for best results

Robust cash flow is a must for virtually every kind of business. Yet an improperly or inadequately managed inventory system can drag down your revenues. It's a good idea to regularly review your approach to inventory accounting.

Reconsider your approach

Generally, there are two primary inventory accounting methods for both tax accounting and financial accounting. They are:

1. Last in, first out (LIFO). If you tend to retain inventory items (such as repair parts or durable goods) for long periods, LIFO may be your best choice. It allows you to allocate the most recent (and, therefore, higher) costs first, ideally maximizing your cost of goods sold and minimizing your taxable income.

2. First in, first out (FIFO). This refers to selling the oldest stock first. Generally, FIFO works best with dated goods, perishable items and collectibles. In an inflationary market, this approach usually results in higher income as older purchases with lower costs are included in cost of sales. (In a deflationary market, the opposite generally holds true.)

Of the two, FIFO is used more often because it more genuinely reflects the typical normal flow of goods and is easier to account for than LIFO, which can be highly complex and deals with inventory costs (not the actual inventory) that may be many years old.

If you're dissatisfied with your company's method, you may be able to change it. But doing so is generally not simple. Should a business wish to change its inventory accounting method for tax purposes, it needs to request permission from the IRS. And if it wishes to change for financial accounting purposes, it needs a valid reason. This is why changes in accounting for inventory are not routine.

Tend to your garden

As you review your inventory accounting, try to drill down and pinpoint as many discrepancies as possible. By identifying the source of accuracy problems, you can figure out the best solutions. After all, your inventory is like a garden. Left untended, it will grow out of control or die on the vine. Manage yours carefully, however, and it should bear profitable fruit.