Can I have a decrease in inventory and still have an increase in LIFO reserve?

Although it seems contrary to logic, the answer to the question is yes, the reserve can increase despite decreasing inventory levels. The reason is that the key to a LIFO computation is the level of inflation in inventory costs, not the quantity of the inventory. For example:

Assume your business has 100 units in inventory for the first year, and they are equally priced at $10,000. Also, assume inflation for the year is 5%. Each unit would have a LIFO benefit of about 5% of its cost, or $500. The total LIFO reserve for the 100 units is $50,000.

The next year the inventory drops to 90 units, and inflation is again 5%. This means that each of the remaining units has a LIFO benefit of 10% (5% + 5%), or $1,000. The total LIFO reserve for the second year is $90,000, an increase of $40,000 despite the drop in inventory. The amount of inflation on the remaining units easily negates the fact that there were fewer units in inventory. Granted, it would have been better if the inventory had remained at 100 units, but it didn’t cost the business any of its previously acquired LIFO reserve.

Obviously, this is a simple example but it illustrates the principle that inflation, not quantity of units, is the most important factor in a LIFO computation. You can use the rationale of the example above to determine at what level of inventory and inflation your reserve might begin to decrease. It will probably surprise you to see how low the inventory can drop without decreasing the reserve.

SOURCECORP Tax Benefits Group links:
Cost Segregation Consulting | Dealer Discount Consulting | Fixed Asset Consulting

http://www.lifosystems.com/publications/decrease_inventory.htm
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You must understand that LIFO means last in, first out. In theory, the last item you purchased, at the highest current year price, is the first one sold. In periods of rising inflation, this means that the cost of goods sold is computed from the highest priced items.

There are instances, however, where not all of the items purchased during the current year are sold. The result of this is increased inventory. While LIFO is a benefit when you compare the actual cost of inventory (the price you actually paid for it) to the value of the older inventory you pretend to have in inventory (because you expensed the newer, higher priced items), there is no LIFO benefit in the current year for the part of the inventory which was purchased in the current year because its value for LIFO purposes is the same as its actual cost.

Consider the following example:

Year 1 inventory - 100 items @ $10 each.

Year 2 inventory - 100 items @ $11 each. Purchases for the year - 1,000 items @ $11.

Year 3 Inventory - 200 items @ $12 each. Purchases for the year - 1,000 items @ $12.

The LIFO benefit for year 1 is $0 because the actual cost of the inventory is $1,000 (100 x $10), and the LIFO cost of the inventory is also $1,000 (100 x $10).

In year 2, you can see that the company purchased all its inventory items for $11 each, demonstrating that there was 10% inflation during the year. All of the year's purchases were sold during the year, and the ending inventory was 100 units, again.

The LIFO benefit for year 2 is $100 because the actual cost of the inventory is $1,100 (100 x $11), and the LIFO cost of the inventory is $1,000 (100 x $10).

In year 3, the same number of units were purchased, at an even higher price, but not all the items were sold, leaving an ending inventory of 200 units. Because we are using the principle of last in, first out, we can assume that the inventory that is left is the 100 units with which we began the year (@ $10 each), and an additional 100 units purchased early during the current year (@ $12 each).

The LIFO benefit is computed by comparing the actual cost of the inventory to its LIFO value. Here is the math: actual cost = $2,400 (200 x $12). LIFO cost = $2,200 ((100 x $10) + (100 x $12)).

As you can see, the LIFO benefit on the 100 units considered purchased during the current year is $0 because the same LIFO value is assigned to it as to the actual cost ($12 each). The only benefit which is increased is that which is based on the older 100 units @ $10 each.
Can I have an increase in inventory and still have a decrease in LIFO reserve?

Although it seems contrary to logic, the answer to the question is yes, the reserve can decrease despite increasing inventory levels. The reason is that the key to a LIFO computation is the level of inflation in inventory costs, not the quantity of the inventory. For example:

Assume your business has 100 units in inventory for the first year, and they are equally priced at $10,000. Also, assume inflation for the year is 5%. Each unit would have a LIFO benefit of about 5% of its cost, or $500. The total LIFO reserve for the 100 units is $50,000.

The next year the inventory increases to 110 units (still equally priced at $10,000 each), but this year there is deflation at the rate of 3%. This means that each of the remaining units from the first year (100) has a LIFO benefit of 2% (5% - 3%), or $200. The additional ten units have a negative LIFO benefit of 3% each, or negative $300. This makes the total LIFO reserve for the second year $17,000, a decrease of $33,000, despite the increase in inventory.

Obviously, this is a simple example but it illustrates the principle that inflation (or deflation), not quantity of units, is the most important factor in a LIFO computation.
Why would a business choose LIFO accounting?

If your inventory costs are increasing, LIFO allows you to reduce income taxes and keep more cash in your business.

What types of businesses can benefit from LIFO accounting?

Any business with rising inventory costs. It does not matter how large or small the inventory items are.

Which types of businesses would not benefit from LIFO accounting?

Businesses with declining inventory costs should not use LIFO. In addition, businesses that do not pay taxes and do not expect to do so for the foreseeable future have no reason to elect LIFO.

How can I elect LIFO?

Simply attach a LIFO election form to the tax return for the year you want to elect LIFO and send a copy of it to Washington, D.C. It is automatically approved.

Why would I want to defer income? Or, If it's only a deferral, why elect LIFO?

Because LIFO generates cash, interest-free. Businesses find it more challenging today than ever to stay competitive. It is not often that an interest-free loan is made available.

To put it in another perspective, why do you contribute to an IRA, a 401K, or other retirement account? You do it even though you know you will pay taxes on the contributions and the earnings some day. The reason every business should consider LIFO accounting, is that, properly invested, deferred income taxes compound into hundreds of thousands and even millions of dollars.

I'm on LIFO and will probably have less inventory at the end of this year than I did at the end of last year. How will this affect my LIFO reserve?

Unless you have significantly decreased inventory, or inventory unit costs have declined during the year, your LIFO investment account should increase even when inventory levels drop.

Is it possible to "turn" inventory too often, or too infrequently, to make LIFO a worthwhile alternative?

NO! Inventory turns have absolutely nothing to do with LIFO benefits.
I'm already valuing my inventory at "Lower of Cost or Market". Why would I want to consider LIFO accounting?

Many people have not considered LIFO because they think they are getting all the benefit they can from write-downs. In fact, write-downs are not an effective tax planning tool because you must recapture the tax benefit as soon as the written-down inventory is sold. With a LIFO election, the benefit is not attached to any individual item, and the benefits can continue to increase every year. When you understand this concept, there is no real choice - LIFO is far superior to write-downs.

How long do LIFO benefits last?

The LIFO election continues until the business' inventory is sold or until the business elects to discontinue LIFO.