UNDERSTANDING LIFO: AN EXPLAINER

Last In/First Out (LIFO) is an accounting method used by many businesses that maintain inventories. It is used to clearly determine both "book" income and tax liability, and it has been an accepted and established accounting method in the United States for both purposes for more than 80 years.

Key Facts:

- LIFO inventory is best suited for businesses where the cost of inventory keeps rising.
- It best matches the cost of businesses' replacement inventory to the cost of the product they are selling. In other words, **LIFO matches businesses' cash flow.**
- LIFO is intended to maximize cash flow so a business can replenish inventory and not have to scale back because the cost of new inventory is rising.
- **LIFO is an assumption of the flow of costs, not inventory.** Inventory is sold in a normal manner.
- Contrary to a common misconception, businesses don't actually maintain their old stock. There are no 25-year-old cans of soda in inventory.

LIFO Reserve:

The LIFO Reserve is the calculated difference between First In/First Out (FIFO) inventory and LIFO inventory. *A common misconception is that this difference results in a permanent deferral, or a "loophole." This isn't the case.* ***The tax on LIFO is deferred, but not forgiven.*** *It is paid when a recapture event occurs, as outlined below.*

LIFO results in a larger Cost Of Goods Sold (COGS) because it assumes that the last item purchased (at a higher cost) is the first item sold. **A higher COGS means a lower inventory figure.**

The difference between this lower inventory figure under LIFO and the higher inventory figure under FIFO is called the LIFO Reserve.

Each year's addition to the LIFO Reserve is called an "increment." **The LIFO Reserve is the accumulation of each year's increment.**

If a business reduces its inventory (like oil & gas did during COVID-19), COGS will decline. This is due to the lower cost of earlier inventory. This process is called "dipping" into or recapture of the LIFO reserve.

Recapture of the LIFO reserve results in payment of deferred taxes. Other recapture events include when a C corporation switches to be an S corporation, or a business ceases operations.

This "toggle" effect is exactly how LIFO is supposed to work. The tax benefit only occurs if the cost of inventory keeps rising and the business maintains inventory balances.

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LIFO ILLUSTRATION

Assume that a company has an inventory of 12 widgets, A – L, purchased in alphabetical order. The cost of these widgets is as follows:

Widget	A	B	C	D	E	F	G	H	I	J	K	L
Price	$5	$10	$15	$20	$25	$30	$35	$40	$45	$50	$55	$60

If the company then sold 4 widgets for $75 apiece (totaling $300), we can compare accounting methods to see how LIFO works. LIFO assumes that the last four items purchased (L – I), highlighted in blue, were the first 4 items sold, whereas FIFO assumes that the first 4 items purchased (A – D), highlighted in yellow, were the first 4 items sold.

	FIFO		LIFO		LIFO Reserve
Sales	$300		$300		
COGS	$50	(A-D)	$210	(L-I)	
Profit	$250		$90		
20% Tax	$50		$18		
Remaining Inventory	$340	(E-L)	$180	(A-H)	$160

Key Takeaways:

- *The LIFO Reserve is the difference between the FIFO remaining inventory and the LIFO remaining inventory ($340 – $180 = $160).*
- *The LIFO accounting method allowed for $32 of deferred taxes ($50 – $18 = $32) to be used in the business NOW.*
- *The $32 of deferred taxes will eventually be paid when a recapture event occurs ($160 LIFO reserve * .20).*
- *LIFO maximizes the cash flow for businesses with rising inventory costs. FIFO accomplishes the same thing for companies selling inventory that declines in price.*

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