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Reporting and managing inventory

Ineffective inventory management and reporting can result in bloated working capital and impaired business profits. In industries that rely on overseas suppliers, best practices for managing inventory may have recently changed. In today's uncertain marketplace, it's clearly a good idea to review your current approach and make adjustments as needed.

What's the right reporting method?

Accurate recordkeeping is fundamental to effective inventory management. Generally, there are two primary inventory accounting methods for tax and financial accounting:

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. That's 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.

Should your company change it's approach?

If you're dissatisfied with your company's method, you may be able to change it. But doing so generally isn't 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 aren't routine.

Are you managing inventory efficiently?

For many companies — including retailers, manufacturers and contractors — inventory represents a significant item on the balance sheet. Excessive amounts of inventory can drain working capital (current assets minus current liabilities). This can prevent your company from pursuing value-added business endeavors, such as launching new products, purchasing machines or hiring new salespeople to generate additional revenue.

Conversely, lean (or just-in-time) inventory practices may reduce storage and security costs, freeing up cash, while allowing you to keep a closer, more analytical eye on what's in stock. In some cases, you may need to upgrade your company's existing inventory tracking and ordering systems. Newer ones can enable you to forecast demand and keep overstocking to a minimum. In appropriate cases, you can even share data with customers and suppliers to make supply and demand estimates more accurate.

However, there's a limit to how "lean" a company can operate. During the pandemic, many companies have learned that carrying a reasonable amount of "safety stock" can help avert a supply chain crisis. Previous assumptions about optimal inventory levels and reorder points may need to be adjusted to reflect current supply chain risks.

We can help

The first step when reviewing your company's inventory practices is to identify sources of inefficiencies. From there, you can figure out the best solutions. Contact us for guidance on inventory reporting methods and best practices in your industry.