IDEAS

ASK ALAN | BY ALAN FRIEDMAN

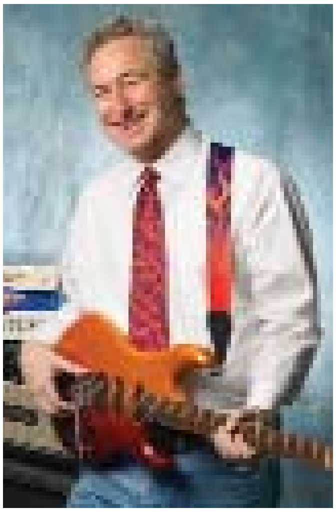
INVENTORY VALUATION: A MOVING TARGET

Inventory valuation impacts a financial statement's balance sheet and P&L, as well as the amount of income tax paid. Without an accurate inventory valuation, net profits can be materially overstated or understated, causing endless problems for a business owner.

In the last five articles of this year-long series on inventory management, we've dealt with the nature of music retail inventory and many of the challenging issues surrounding it. This article will deal with arguably its most elusive aspect: how to value it for financial and tax-reporting purposes.

A word of warning. Yes, I am going to deal with the most taboo subject of inventory valuation: the purposeful overstatement or understatement of inventory reported on financial statements and tax returns. Trust me, you won't be happy as I attempt to humiliate and guilt you into the proper valuation and reporting of inventory.

But like a big, distasteful spoonful of medicine, properly valuing your inventory will, in the long run, make you feel better and potentially make your business healthier. I can hear the groans already.



Tracking inventory worth and its impact on profits and taxes

INVENTORY VALUATION 101

Before I start lecturing you, let's go over some inventory valuation basics. One goal of any business is to determine accurately how much net profit has been made during a given time period. To do so, we must accurately account for all revenues and expenses in that period.

Sales is easy— add up the money you've collected and factor in your accounts receivable (sales made but not yet collected). Operating expenses is equally as straightforward — add up the money you've spent and factor in any accounts payable (expenses incurred but not yet paid for). But as most of you know, there's one major expense most music dealers find difficult to determine: the cost of goods sold.

The easiest way to calculate cost of goods sold is to start with the inventory value at the beginning of a time period (let's assume a year), add what was purchased during that year and subtract the inventory value at the end of the year. This assumes inventory that's no longer around has been sold — or stolen.

Since it's easier to physically count and cost your year-end inventory than to look up the invoice cost for the hundreds or thousands of products you've sold during the year, most businesses use this method with the help of their computers. I agree this is the preferable and arguably best method of valuing inventories and calculating costs of goods sold, but it also has its share of problems.

INVENTORY INSANITY

I could fill up this whole magazine on the difficulties and oddities of determining an accurate inventory on any given day.

Shrinkage, returned and consigned goods, and counting, costing and timing problems between the arrival of inventory and receipt of its corresponding invoice are just a few reasons why inventory can be a moving target.

To illustrate this point, let's assume it's the end of your fiscal year and you've finished counting and reconciling your inventory against what your computer says you have in stock. You print a list of your inventory, and it totals $500,000 at cost, including freight-in. But you've accidentally included $10,000 of consigned goods in your valuation. You've also included an early shipment of $30,000 of step-up band instruments received on the last day of the year but without a corresponding P.O. or invoice (which hasn't been included in accounts payable). And there's $20,000 of old gear that's now worth less than $1,000. (Remember, an item is only worth its cost when there's a chance of selling it above that cost.)

Now look at the chart below. If these common occurrences have taken place and you aren't aware of them or haven't adjusted them, the left side of the chart is the fantasy you're reporting. The right side is the reality. You now have a gross mis-statement of cost of goods sold, gross profit and, ultimately, net income. Bad, very bad.

	IN THEORY	IN REALITY
SALES	$1,000,000	$1,000,000
COST OF GOODS SOLD		
Beginning Inventory (Jan. 1)	400,000	400,000
Purchases	750,000	750,000
Total inventory available for sale	1,150,000	1,150,000
Ending Inventory (Dec. 31)	(500,000)	(440,000)
COST OF GOODS SOLD	650,000	710,000
GROSS PROFIT	350,000	290,000

RULES FOR THE GOOSE & GANDER

As most business owners have different reporting objectives for financial statements and tax returns, there are different ways of valuing inventory for book and income tax purposes. The following are more common methods allowed by Generally Accepted Accounting Principles:

First-in, first-out (FIFO). The FIFO method of valuing inventory assumes the earliest inventory purchased is the first to be sold. During periods of inflation, the use of FIFO will result in a lower cost of goods sold, higher inventory value and higher net income.

Last-in, first-out (LIFO). The LIFO method assumes the latest inventory purchased is the first to be sold. During periods of inflation, the use of LIFO will result in a higher cost of goods sold, lower inventory value and lower net income.

Weighted average. Under this method, both inventory and cost of goods sold are based on the average cost of all items bought during a period.

Specific cost. Under this method, both inventory and cost of goods sold are based on the actual cost for each item bought during the period.

Each of these inventory valuation methods have varying effects on net income, income taxes paid and cash flow. But just because the LIFO method results in lower taxable income doesn't mean it's right for your business.

Also note that once you pick an inventory valuation method, you generally have to stick with it. You can't change methods every year without raising eyebrows from bankers, credit managers and the IRS. What's most important is having a good handle on your inventory levels, turns, GMROI, resulting cash flow and, of course, your store's profitability, or lack thereof.

DON'T BE STUPID ABOUT TAXES

Here's where I start to upset you. While the amount of income taxes you pay is important, it's a secondary issue, in my opinion. Fixing a cash-flow problem will be much easier when it's the result of a profitable store's growing tax liability, as opposed to an unprofitable store that pays no tax. I'll never understand the store owner who insists on paying no income tax whatsoever, without any regard to whether the store is profitable.

Some of you have figured out that you can inflate net income by inflating your year-end inventory value. I would never condone the purposeful overstatement of inventory by a music products retailer. Why? When you over-inflate inventory, you're lying to yourself about the profitability of your business and lying to the reader of your financial statements. (Ever heard the term "bank fraud"?)

You're also exposing your accountants to greater risk when they sign off on your financial statements, and possibly, you're paying too much in taxes on the overstated income. Lastly, you're putting off the inevitable: dealing with the lack of profits when the valuation issue reappears next year. No, it doesn't go away.

Conversely, you now know you can reduce taxes by lowering your year-end inventory value. I don't advocate this either, unless it's warranted and legitimate. But contrary to popular belief, I don't want to see anyone pay more than his or her fair share of tax.

SOME COOL TAX TIPS

If your store is financially healthy and your bankers are behind you, you may want to consider the tax minimization strategy of writing down or writing off inventory. There are certain instances when inventory can be valued at less than cost or written off completely.

Using the "lower of cost or market" method of inventory valuation, taxpayers can value items at the lower of cost or market price. (Market price generally means the current street price.) IRS regulations let inventory be valued lower than its cost if it was offered for sale prior to year-end at a price lower than its replacement cost.

There are a few other legitimate ways to get tax relief via the reduction of inventory. For example, a "C" corporation can donate inventory to qualified organizations like schools and receive a limited deduction of up to two times the cost basis of that inventory.

FINAL THOUGHTS

But more important than tax deductions is the overall management of your inventory. Believe me, you won't remember the tax benefits of showing losses every year when it's time to retire and sell your business, and nobody will give you a dime for your loser store.

Take measures to nail down the moving inventory target. Without a true valuation, you'll never know how much money you're making, or not making. You're also going to frustrate your accountant, which will turn him or her into an even more miserable human being, if that's possible. **MI**

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