



Navigating Accounting[®]

LIFO/FIFO Inventories: How Do I Use the Numbers?

Industry Comparisons Exercises Series 01

Comparing the impact of inventory accounting methods across industries and time; and analyzing ratios based on the adjusted numbers.

Search



This exercise requires you to search for information.

Compute



This exercise requires you to compute information.

Usage



This exercise helps you learn how accounting reports are used by investors, creditors, and other stakeholders.

Judgement



This exercise helps you learn how to use judgement.

Part 1(a) Question

- Fill in the blank boxes (with red borders) in the “Part 1” of the Excel worksheet.

Part 1(a) Guidance

- If you have not already done so, go to NavigatingAccounting.com and then click your way to the materials for this exercise:
 - Click “Analyzing Financial Statements Across Time and Industries”
 - Industry Comparisons Exercises: Series 01
 - Click “Exercise 6: LIFO/FIFO Inventories and Ratio Analyses”
- Download the Excel and Word files.

Part 2 Question

- Compare and contrast what you learn from the ratios in the data template for the six companies and years therein, ignoring fiscal-year-end differences.

Part 2 Guidance

- **Limit your analyses to:**
 - The ratios in the data template.
 - Your understanding of the six companies’ businesses and the ways they were likely impacted by the recent financial crisis. Your understanding of the companies’ businesses should be informed by related excerpts from the Management Discussion and Analysis (MD&A) and can be informed by any other published sources you elect to use and cite.
 - CNH is a Netherlands company that competes with John Deere and Caterpillar. CNH files a Form 20-F with the SEC rather than a Form 10-K. The financial statements in its 20-F are prepared in accordance with US GAAP. Item 5 of the 20-F, Operations and Financial Review and Prospects, is similar to the MD&A in a 10-K. You can download 20-Fs from the investor relations section of CNH’s web site.
 - Things you learned about the companies in previous assignments and related class discussions.
- **Organize your response around the following questions:**
 - (a) Analysts use ratios to compare performance across time, industries, and companies within industries. These comparisons can sometimes be improved significantly by adjusting reported numbers so they are based on comparable accounting methods.

Identify conclusions an analyst would likely change after converting LIFO-based ratios in the data template to FIFO-based ratios. For example, identify ratios where analysts would rank companies’ performances incorrectly if they did NOT convert reported LIFO numbers to FIFO. (Indicate the companies and how the rankings changed.)

Similarly, identify places where the ratio comparisons changed significantly enough so analysts would likely modify the strength of their conclusions.

- (b) Discuss reasons inventories are a smaller percentage of total assets for the companies in the capital goods industry than for the drug store companies in the data template prior to fiscal 2007 (even after converting the ratios to a common FIFO basis). Assume all significant assets are reported on the balance sheets and measured correctly. Given this assumption, explain how differences in the assets reported on balance sheets relate to differences in the businesses and how these business differences explain differences in the ratio of inventories to total assets. We will relax this assumption in a later assignment, which will help you better understand these ratio differences.
- (c) A big event occurred in fiscal 2007 for CVS Caremark. What was this event and how did it change the company's ratios? Be very explicit, explaining which ratios changed thereafter and why they changed as a result of this event.
- (d) Explain the reason Caterpillar's fiscal 2008 FIFO-based cost of sales was less than its fiscal 2008 LIFO-based cost of sales, but just the opposite was true in fiscal 2009: FIFO-based cost of sales exceeded LIFO-based cost of sales. First, explain what happened in terms of the numbers needed to convert LIFO to FIFO. Second, explain how this relates to something Caterpillar did in response to the financial crisis. Hint: Reread the conference call transcript for the fourth quarter earnings release in fiscal 2008 (discussed in Exercise 4: DuPont Model and Financial Reporting Environment).
- (e) Compare and contrast how the financial crisis affected the ratios in the template for the two industries. If ratios changed because of the crisis, explain the changes in terms of changes occurring in the businesses.