

Exclusive Outlook

WEST COAST ASSET MANAGEMENT, INC.

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Inventory: Trick or Treat

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We have been known to refer to “inventory” as the dirtiest word in business. Certainly inventory presents one of the great management challenges, and one of the great valuation mysteries when considering a company for investment. Annual reports and financial statements estimate the value of inventory on hand, but the number cannot always be taken at face value.

In 1992, the director of Florida International University’s Center for Accounting, Auditing and Tax Studies told the Wall Street Journal, “When companies are desperate to stay afloat, inventory fraud is the easiest way to produce instant profits and dress up the balance sheet.” We’ll cite some examples, but *even when inventory is properly managed and properly accounted for, its true value may not be obvious to the prospective investor.*

ROGUE’S GALLERY OF FRAUD

A web search on “inventory fraud” turns up many references to the “Salad Oil Scandal,” which was an audacious scam uncovered in 1963. Apparently, the Allied Crude Vegetable Oil Company learned that banks would make loans secured by inventory. Since oil floats on water, the company easily faked massive inventory by filling tanks with water and floating some oil on top for the benefit of inspectors. When the fraud was finally discovered, over \$175 million in salad oil was missing, and that’s a lot of lettuce.

Another famous inventory-related fraud involved the Crazy Eddie’s appliance/hi-fi chain. Crazy Eddie’s low-budget, high-energy television ads were a legendary

late-night staple in the northeast. The conspirators in this case used nearly every possible trick to fool auditors and overvalue their inventory. They offered to help the auditors, then simply exaggerated counts in the warehouses. They got suppliers to ship merchandise but hold the invoices. They moved stock between stores so it would get counted twice. Thus, Crazy Eddie’s appeared very profitable, because their revenues seemed to come from selling fewer items at higher margins.



Bristol-Myers Squibb settled charges this August stemming from a scam in which they inflated sales by \$2.5 billion over a three-year period by making wholesalers buy more products than they could sell. Studies have shown that misstated asset valuations account for nearly half of all financial statement fraud, and over-valued inventory makes up nearly all of the exaggerated asset valuations.

THE VALUE OF INVENTORY

Scoundrels manipulate inventory not just because it is easy, but also because it is important to the valuation of the company. Inventory represents assets, at least from an accounting point of view. But determining the value of inventory is problematic. Joseph T. Wells, founder of the Association of certified Fraud Examiners, explained it this way:

“The valuation of inventory involves two separate elements: quantity and price. Determining the quantity of inventory on hand is often difficult. Goods are constantly being bought and sold, transferred among locations and added during a manufacturing process. Figuring the unit cost of inventory can be problematic,



too; FIFO, LIFO, average cost and other valuation methods can routinely make a material difference in what the final inventory is worth.”

Items in stock come and go throughout the accounting period, often at diverse prices, so a standard must be applied. “FIFO” refers to first in, first out; whereas “LIFO” refers to last in, first out. Under FIFO accounting, the ending inventory is based on the cost of the most recent units brought into inventory, whereas under LIFO, the ending inventory is based on the oldest units in stock.

THE GAME OF LIFO

Companies choose LIFO or FIFO to suit their particular type of inventory, usually related to how an item's value or cost typically changes over time. As shown in the table, when prices are rising, FIFO gives a lower cost of goods sold (COGS) and a higher income amount than LIFO. Under the same conditions, LIFO equates to lower income and therefore lower taxation, which improves cash flow. Of course, when prices are dropping, all of this is reversed.

The key concept to keep in mind is this:

Gross margin (profit) equals sales minus cost of goods sold.

How a company accounts for inventory determines the cost of goods sold, and therefore the apparent profit. We may better understand the profitability of a company using LIFO, because the cost of goods sold is based on the most recent inventory, which more closely resembles today's actual costs.

When a company changes from one method to the other, such as Chrysler did in the seventies, they are often trying to manipulate value, and we are highly suspicious of such drastic changes. Sometimes, the change in inventory accounting

methods is announced by nothing more than a footnote in the annual report. Companies will often make such moves to avoid violation of debt covenants or to make earnings appear stronger than they really are. Prospective investors must read between the lines of the financial statement.

THE INVENTORY MANAGEMENT TIGHTROPE

In addition to how inventory is counted and valued, we must understand its role in the day-to-day business. Generally, we don't like inventory because it costs money to buy and costs money

to store, but some companies must maintain high levels. In fact, some make inventory their competitive advantage. Home Depot has to maintain a massive inventory, because if they run out of hammers, people can get them (and everything else) at Lowe's.

Technology companies, on the other hand, need to keep inventory levels as low as possible, or they risk getting stuck with obsolete products. Many software companies have become service companies and carry NO inventory, delivering all products and updates online. Computer hardware keeps improving, but the prices continue to drop. Manufacturers face the risk of obsoles-

cence nearly as soon as a product is released.

Seasonality also affects the value of inventory. A large supply of lawn care products in the northeast becomes a lot less valuable as winter approaches. Home Depot can transfer lawn care products to their stores in the southwest as snow falls in the northeast, but toy stores walk a considerably higher tightrope. On December 20, a high inventory level is very valuable. On December 26, leftover inventory becomes a liability (unless we're talking about an antique toy store; more on that later).

SUMMARY OF EFFECTS

Assuming Rising Prices & Stable or Growing Inventory

ACCOUNTING METHOD	FIFO	LIFO
Cost of Goods Sold	Lower	Higher
Pretax Income	Higher	Lower
Income Tax	Higher	Lower
Net Income	Higher	Lower
Return on Assets	Higher	Lower
Return on Equity	Higher	Lower
Current Ratio	Higher	Lower
Inventory Turnover	Lower	Higher
Cash Flow	Lower	Higher

The above chart illustrates the affects of FIFO (first in first out) accounting method vs. LIFO (Last in first out). As highlighted above, LIFO results in lower income taxes and higher cash flow, while FIFO creates the perception of a healthier company on the surface.

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ADDING VALUE, NOT REVENUE

Understanding the role of inventory includes understanding inventory that adds value without directly adding revenue. Many service-oriented companies offer amenities that enhance customer experience but are not sold. For example, Kinko's used to provide glue sticks, White-Out, tape, pens, pencils, paper cutters, hole punches and highlighters for customer use. These items were brought into inventory, but never sold.

Dogmatic bean counters often miss the added value of such amenities and their effect on customer loyalty. We've seen executives lobby for the removal of such conveniences, even though it would be like removing salt and pepper from restaurants because condiments are not a profit center.

Kinko's provides another example of misunderstood inventory. The stationery items carried by Kinko's generated lower profit margins than the company's "manufactured" goods, such as Xerox copies and laser prints. Therefore, stores that sold a lot of stationery had a higher cost of goods sold and a lower overall margin, at least in percentages. While preparing to sell or take the company public, management actually discouraged stationery sales so the overall profit percentage would look better, even if the actual profit dollars were lowered. We find such strategies perplexing, because as we often say, "you don't take percentages to the bank."

TAKING CARE OF TURNOVER

Elvis Presley famously wore a diamond-encrusted ring that said "TCB," for "taking care of business." An acquaintance of ours who managed a Kmart store in the mid-seventies wore a gold ring that said "TO," for "turn-over." "Turnover was our mantra in those days," he explained. "We bought merchandise on a 90-day net arrangement, and tried to turn the entire store every two weeks."

In other words, when all was going well, they would sell every item in the store and earn profit six times before they paid for the first batch of inventory. Clearly there's more to great management than turnover, but anyone saddled with an inventory-intensive business better be obsessed with turning that merchandise.

Some inventory is more liquid and less risky. Inventory that turns reliably and quickly, like that of Coca-Cola,

Wrigley, and Hershey, is probably as good as cash, and we think pretty highly of cash when researching prospective investments.

SOLVING THE INVENTORY MYSTERY

Sir Arthur Conan Doyle's Sherlock Holmes often noted that false modesty was no less a lie than bragging. Likewise, over-valued inventory is not the only mystery to be investigated by prospective investors. Hidden assets may also lurk in inventory; consider the antique toy store reference above. Trendy toys are a liability after the holiday season, but antique toys do not lose value. Any product or commodity that appreciates over time could easily - and honestly - be undervalued in a financial statement.

In general, we like to remember that "ending inventory" often represents merchandise or materials that simply didn't sell. In the fashion industry, the best styles sell quickly and the rest hang in the store, losing value every day. The same logic applies to computer chips, cars, and furniture.

Investors need to look far beyond the quantity and reported value of items in inventory. To understand the real meaning of this and other assets, one must understand the methods of valuation, the nature of the products in inventory, and the external market factors that might affect value in the real world, which may or may not bear any resemblance to the financial statement. ▲

SEEING IS BELIEVING

In 1970 it took the economy 1.31 barrels of oil to produce \$1,000 of GDP (measured in 2004 dollars). This year oil intensity will likely fall to .64 barrels. As a percentage of GDP, the U.S. is producing more goods that don't consume as much oil, including pharmaceuticals, video games, and computers. As a result, the economic impact of oil price changes today is significantly less than it was 30 years ago.

Source: Forbes Magazine

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