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IFRS and the Repeal of LIFO

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Of the possible tax implications of adopting IFRS accounting, probably the greatest is in the valuation of inventories. The reason for this is the numerous differences in inventory accounting methods between IFRS and GAAP. Some of these include the disallowance of Last-in, First-out (LIFO) accounting, the change in the lower of cost or market (LCM) method for writing down inventories, and changes in depreciation, capitalization methods, and fair value. However, of all of these, the greatest in terms of impact and controversy is the repeal of LIFO.

The debate over the repeal of LIFO accounting for inventories with IFRS has been one of the most contested, and most widely talked about issues of all of the differences between IFRS and U.S. GAAP. Under U.S. GAAP one of three inventory accounting methods may be chosen; Last-in, First-out (LIFO), First-in, First-out (FIFO), and the Weighted Average method. In general, firms do not have to be consistent in using the same inventory accounting principles for financial reporting and for taxes. However, when using LIFO for tax purposes, a firm must adhere to the LIFO Conformity Requirement, meaning that it must also use LIFO for financial reporting.[1] In using LIFO, the newest inventories purchased are assumed to be the first ones sold. Using FIFO, the opposite is true. In periods of rising prices, which is generally the case, LIFO creates a higher cost of goods sold, and greater expenses on the income statement. This results in lower net income, which in turn results in lower income tax payable. This is likely the reason that LIFO has been defended so strongly, although there are many who believe that in general, LIFO is only used for earnings management, and that it has no real place in U.S. GAAP.[2] Although there has been much discussion between the International Accounting

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[1] Turgeon, Christine, Scott Rabinowitz, Sean Pheils, and Helen Poplock. *The Uncertain Future of LIFO*. New York: PricewaterhouseCoopers, 2009. PDF.
[2] Kleinbard, Edward D., George A. Plesko, and Corey M. Goodman. "Is It Time to LIquidate LIFO?" *Tax Notes* (2006). *Taxanalysts.com*. Web.

Standards Board (IASB) and the Financial Accounting Standards Board (FASB) over this area of non -convergence in the past, it is not currently under discussion.[3]

Most of the debate over the use of LIFO in the United States is over the LIFO Conformity Requirement. Since a taxpayer must use LIFO for financial reporting if it is also used for tax purposes, if in the future the United States requires an adherence to IFRS, LIFO will not be allowed for financial reporting, and the conformity requirement will be violated. To solve this problem, proponents of LIFO, like the LIFO Coalition, have proposed that the Treasury Department could use its authority to excuse violations of the LIFO Conformity Requirement in certain instances. In defending this position, the LIFO Coalition cites the fact that it is in their belief that the Treasury Department could legally offer a "carve-out" for LIFO inventory accounting, and that this is by no means uncommon. Most countries that have adopted IFRS still maintain a national standards-setting body.[4] Because of this, most countries that have adopted IFRS have implemented a local version rather than a pure version of IFRS as created by the IASB. According to Jack Ciesielski, publisher of the *Analyst's Accounting Observer*, less than sixteen percent of the world's markets are using a pure version of IFRS.[5]

The LIFO Coalition argues that LIFO accounting should be used for many reasons. The first of which is that they believe that LIFO accounting makes sense for companies that have large inventories with rising costs over time, or inventories that are held for a long time.[6] Some specific examples would be oil, automobile or consumer goods companies. However, makers of

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[3] McEwen, Ruth Ann. *Transparency in Financial Reporting: a Concise Comparison of IFRS and US GAAP*. Petersfield: Harriman House, 2009. Print.
[4] West, Jade C. "Response to Request for Comment Included in May 26, 2011, Securities and Exchange Commission Staff Paper." Letter to Security and Exchange Commission. 12 Aug. 2011. MS.

[5] Aubin, Dena. "Analysis: Doubts Emerge Over U.S. Move to Global Accounting." *Reuters*. 25 July 2011. Web
[6] McEwen, Ruth Ann. *Transparency in Financial Reporting: a Concise Comparison of IFRS and US GAAP*. Petersfield: Harriman House, 2009. Print.

whiskey or other distilled beverages show a quite unique perspective on the reasons to use LIFO. Distillers of Bourbon Whiskey are legally required to age their product for at least two years.[7] Because of this, their inventories are quite large and sit on the books for a long time. Consequentially, LIFO reserve can also be very large. Manufacturers of liquor worry that the increased tax burden associated with paying back LIFO reserve would not only hurt distilleries, but others as well. This highlights the possible unintended consequences of LIFO reform. According to Jerry Brown, spokesman for the Wine and Spirits Wholesalers of America, "It's not just the beverage and alcohol industry... a ripple effect" will affect hotels, restaurants, bars, and others that depend on distillers as well. Senator Jim Bunning, from Kentucky, also believes that LIFO repeal will be damaging because it will "harm US companies and favor their foreign competitors at a time of economic distress when we are trying to encourage more US manufacturing."[8]

Proponents of LIFO also believe that LIFO helps to eliminate phantom profits. FIFO does not take into account the increasing costs of replacing inventory, and therefore, often reports phantom profits. For example, if a company is replacing old inventory with new inventory which has a cost equal to the current selling price, the company would not actually be making any profit. However, if the company were using FIFO rather than LIFO, they would be reporting cost of goods sold at past prices, and presenting an unfair portrayal of profits; thus, phantom profits.

Finally, the LIFO Coalition argues that not allowing a carve-out for LIFO users would cause economic disaster. They believe that losing the tax benefits of LIFO and having to take

[7] AFP. "Obama's Budget Has Some Singing Booze Blues." *AFP American Edition*. 8 Mar. 2009. Web.
[8] ibid

back their LIFO reserves into income would cause substantial tax expenditures. The LIFO reserve is, essentially, the difference between the cost-of-goods sold deduction under LIFO and the deduction that would have been taken had the company been using FIFO.[9] The purpose of the LIFO reserve is to retroactively take the tax benefit of using LIFO back into income so that the company may be taxed as if it had never used LIFO.[10] Obviously, this does not seem fair to companies that have been using LIFO since it was first adopted into tax law in 1938.[11] The tax liabilities some companies would face would be enormous. Some also find this unfair because it violates the belief that taxpayers should be able to be fairly certain of the tax liability they face. This, coupled with the struggling economy, would cause severe damage to many companies currently using LIFO.

The following charts, based upon 2010 fiscal year end data, compiled from the Compustat Database display the mean LIFO reserve and the percentage of total inventory attributable to LIFO reserve across several industries. It is easy to see that oil, gas and coal extraction companies have the largest LIFO reserves, followed by manufacturing and chemical companies.

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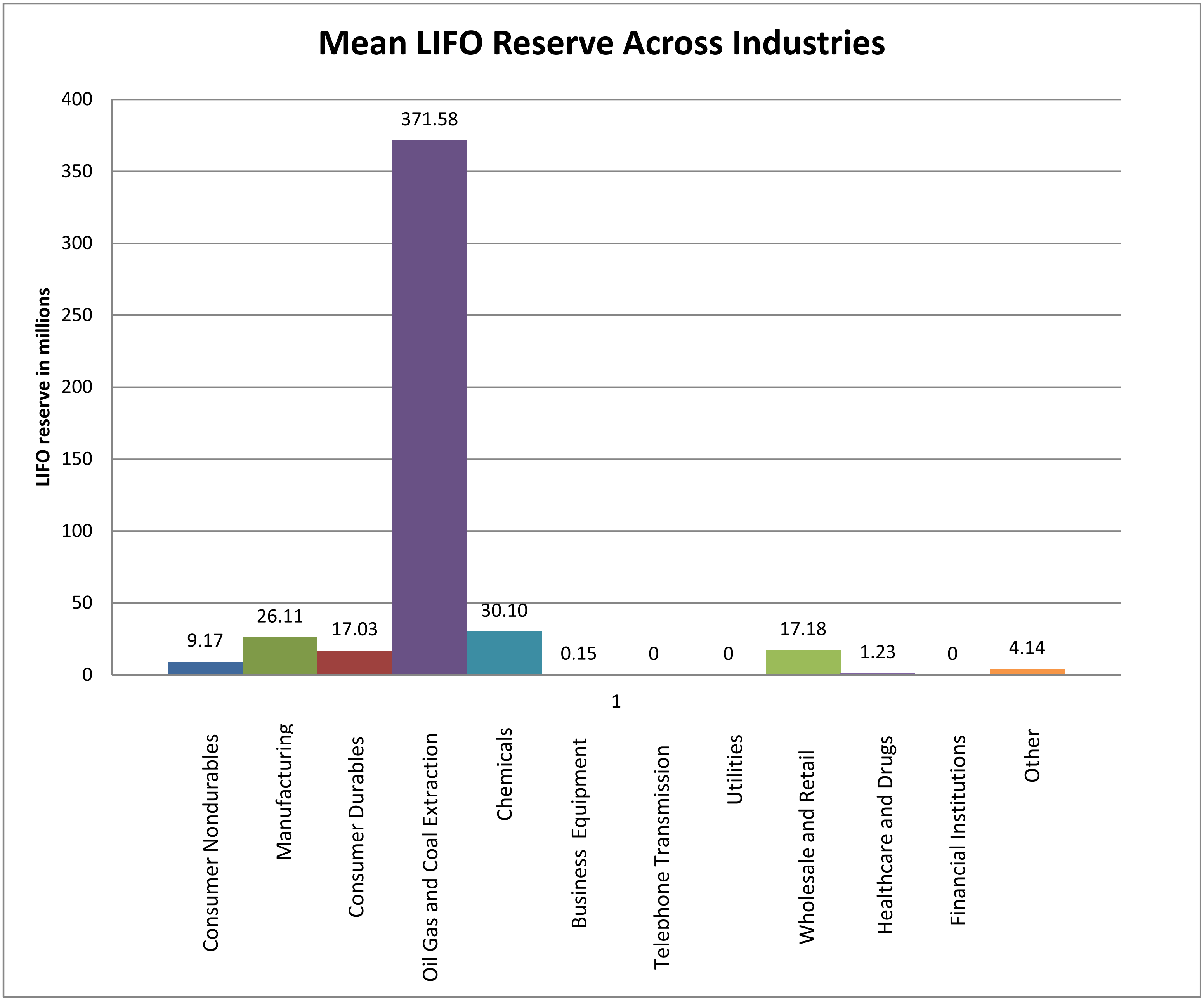
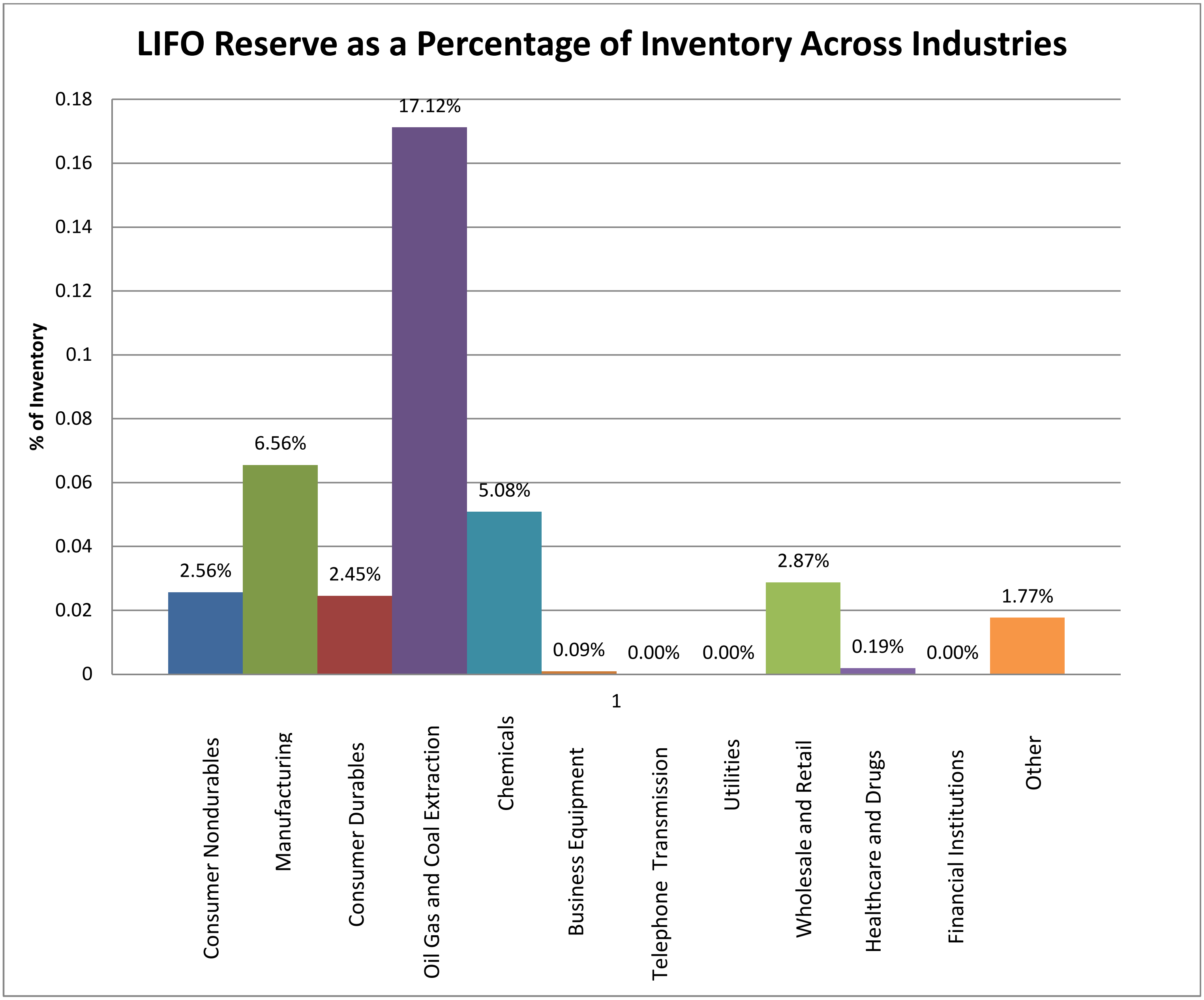
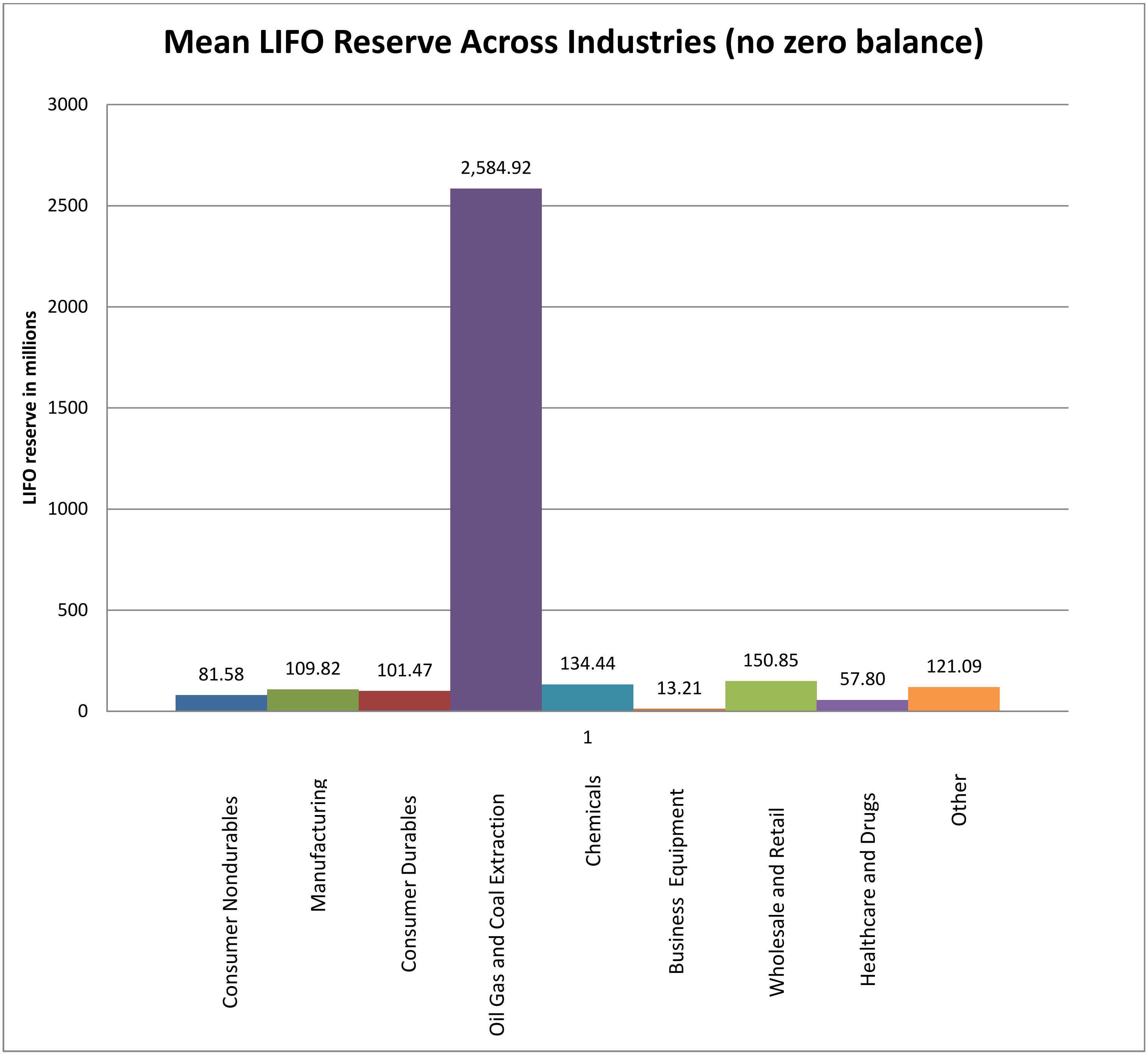
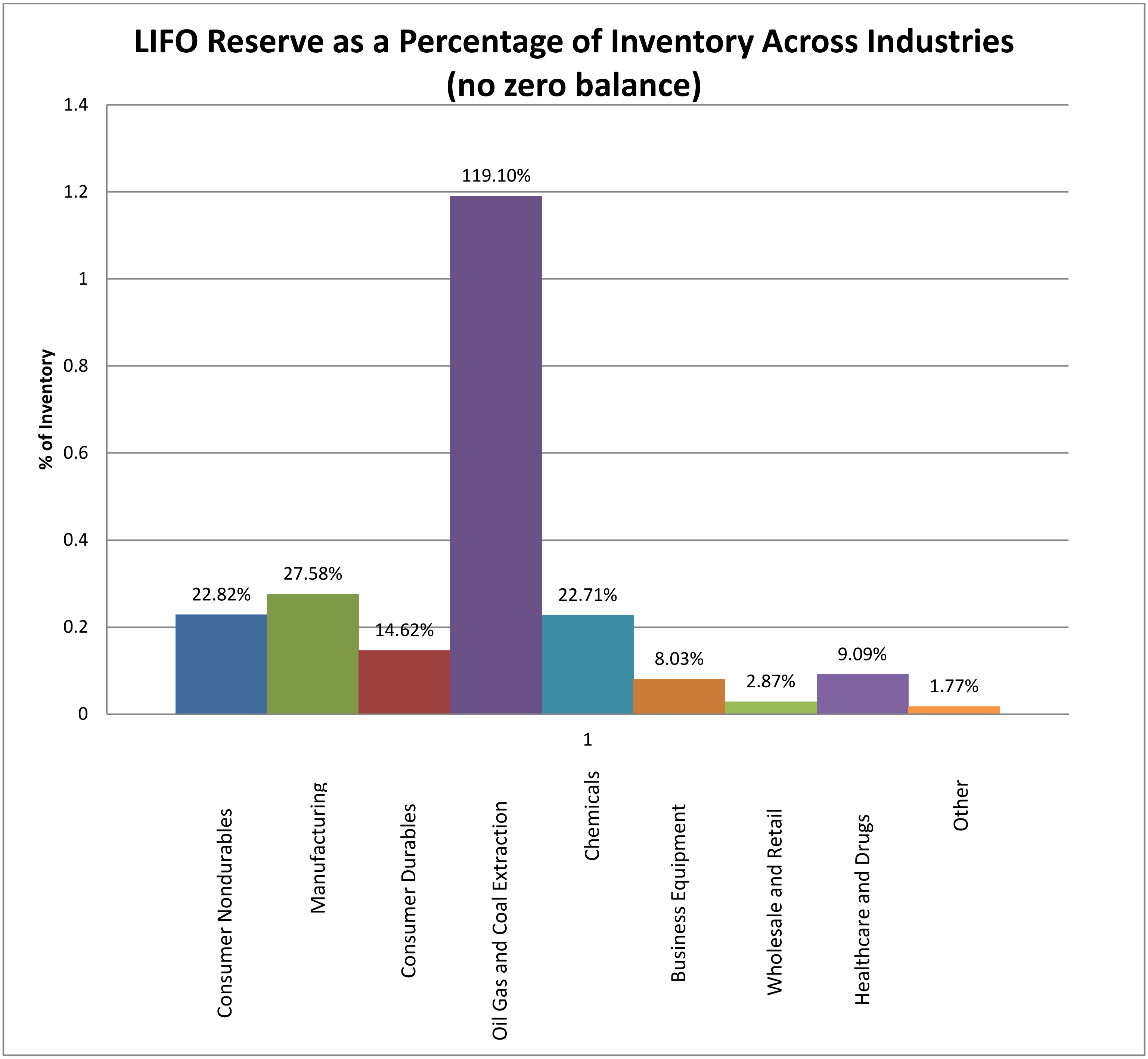
[9] West, Jade C. "Response to Request for Comment Included in May 26, 2011, Securities and Exchange Commission Staff Paper." Letter to Security and Exchange Commission. 12 Aug. 2011. MS.
[10] Starr, George E., David L. Wiseman, Brett E. Cohen, James W. Geary, Patrick G. Durbin, and Luke J. Cherveny. *Guide to Accounting for Income Taxes*. 2007. PDF.
[11] Vitale, Elizabeth G. *A Descriptive Analysis of the Impact of LIFO Repeal*. Thesis. Boston College, 2010. Web.


Mean LIFO Reserve Across Industries
LIFO reserve in millions
400
350
300
250
200
150
100
50
0
9.17
26.11
17.03
371.58
30.10
0.15
0
0
17.18
1.23
0
4.14
1
Consumer Nondurables
Manufacturing
Consumer Durables
Oil Gas and Coal Extraction
Chemicals
Business Equipment
Telephone Transmission
Utilities
Wholesale and Retail
Healthcare and Drugs
Financial Institutions
Other


LIFO Reserve as a Percentage of Inventory Across Industries
% of Inventory
0.18
0.16
0.14
0.12
0.1
0.08
0.06
0.04
0.02
0
2.56%
6.56%
2.45%
17.12%
5.08%
0.09%
0.00%
0.00%
2.87%
0.19%
0.00%
1.77%
1
Consumer Nondurables
Manufacturing
Consumer Durables
Oil Gas and Coal Extraction
Chemicals
Business Equipment
Telephone Transmission
Utilities
Wholesale and Retail
Healthcare and Drugs
Financial Institutions
Other

In order to give a more accurate representation of the amount of LIFO reserve a company may have, the following graphs show data for only those companies that have a LIFO reserve balance. Companies with a zero balance have been removed.


Mean LIFO Reserve Across Industries (no zero balance)
LIFO reserve in millions
3000
2500
2000
1500
1000
500
0
2,584.92
81.58
109.82
101.47
134.44
13.21
150.85
57.80
121.09
1
Consumer Nondurables
Manufacturing
Consumer Durables
Oil Gas and Coal Extraction
Chemicals
Business Equipment
Wholesale and Retail
Healthcare and Drugs
Other


LIFO Reserve as a Percentage of Inventory Across Industries
(no zero balance)
% of Inventory
1.4
1.2
1
0.8
0.6
0.4
0.2
0
22.82%
27.58%
14.62%
119.10%
22.71%
8.03%
2.87%
9.09%
1.77%
1
Consumer Nondurables
Manufacturing
Consumer Durables
Oil Gas and Coal Extraction
Chemicals
Business Equipment
Wholesale and Retail
Healthcare and Drugs
Other

Understandably, when companies with a zero balance in LIFO reserve are removed, both mean LIFO reserve and percentage of total inventory attributable to LIFO reserve increase drastically.

On the other hand, some would argue that there are various other reasons why LIFO should be scrapped. For example, a valid argument against LIFO is the potential for earnings management and misleading financial statements. For the most part, LIFO users carry inventory at the lowest historical costs. If a company has large reserves of inventory that have been on the books for quite some time, there is great potential for understatement of inventory on the balance sheet. On the other hand, if a company were to decide to liquidate old inventory, the net profit from this liquidation would be unusually high because of the low inventory costs related to the transaction.[12] Thus, the potential for earnings management is fairly high. In reporting LIFO liquidations, an explanation is required to be disclosed in the footnotes, however, a casual investor may still be misled.[13]

Many see LIFO as nothing more than a tax break solely for using another form of inventory accounting.[14] Currently almost thirty-six percent of U.S. companies use LIFO accounting. Some of the larger companies in this thirty-six percent include Exxon Mobil Corporation, Chevron, Sherwin-Williams Company, Curtiss-Wright Corporation, Ford Motor Company, Conoco Phillips Co., and Fortune Brands, Inc.[15] Many of these companies belong to the oil industry. With public opinion as low as it is for big oil because of rising gas prices, the BP gulf spill, and the general belief that big business is not paying their fair share, there are

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[12] Vitale, Elizabeth G. *A Descriptive Analysis of the Impact of LIFO Repeal*. Thesis. Boston College, 2010. Web.
[13] "Codification of Staff Accounting Bulletins - Topic 11: Miscellaneous Disclosure." *U.S. Securities and Exchange Commission (Home Page)*. Web. 30 Nov. 2011.
[14] Vitale, Elizabeth G. *A Descriptive Analysis of the Impact of LIFO Repeal*. Thesis. Boston College, 2010. Web.
[15] Ament, Joseph D. "Convergence of International Financial Reporting Standards (IFRS) and U.S. GAAP: Last-In, First-Out (LIFO) Method: Accounting and Tax Implications." Diss. Roosevelt University, 2011. Print.

many incentives to repeal LIFO because of its potential tax effects.[16] Chevron Corporation alone reported on December 31, 2009 that it had total inventories of $4,063,000,000 due to LIFO accounting.[17] One can easily surmise that the potential tax effects of a company like Chevron being forced to take its LIFO reserve into income would be tremendous.

In order to more easily understand the possible tax effects of having to take LIFO reserve back into income, a few specific companies can serve as illustrations. In the following table, five sample companies' LIFO reserves have been taken and multiplied by the highest corporate tax rate (35%) in order to estimate the additional tax burden that they would bear after taking their LIFO reserves back into income.

[16] Ciaccio, Allison. "Fight for Your Right to LIFO: the Oil Industry and Accounting - The Barrel." *Energy Products & Services, Oil, Coal Insight, Natural Gas Shipping, Electric Power Methodology Analysis, Metals, Petrochemical, Reference - Platts*. 10 Dec. 2010. Web.

[17] Ament, Joseph D. "Convergence of International Financial Reporting Standards (IFRS) and U.S. GAAP: Last-In, First-Out (LIFO) Method: Accounting and Tax Implications." Diss. Roosevelt University, 2011. Print.

Company	VECTOR GROUP LTD	FORD MOTOR CO	PACKAGING CORP OF AMERICA	MARATHON OIL	AMERICAN GREETINGS
LIFO Reserve	21.31	865.00	68.08	4,166.00	78.36
x 1,000,000	21,313,000	865,000,000	68,084,000	4,166,000,000	78,358,000
Tax rate (assumed 35%)	0.35	0.35	0.35	0.35	0.35
Extra Tax Liability	$ 7,459,550	$ 302,750,000	$ 23,829,400	$ 1,458,100,000	$ 27,425,300

As stated earlier, it can be seen in this specific example that the tax consequences for taking LIFO reserve back into income can be drastic. The increased tax liability for a company can be in the billions. However, a company is allowed four years to pay this LIFO reserve tax liability. Let us take American Greetings Corporation for example. If American Greetings were forced to change from accounting for its inventory under LIFO to FIFO, the following journal entry would be made.[18]

12-31-2010

Dollar Value LIFO Reserve	78,358,000	
Retained Earnings		50,932,700
Income Taxes Payable		6,856,325
Deferred Income Taxes Payable		20,568,975

12-31-2011, 2012, 2013

Deferred Income Taxes Payable	6,856,325	
Income Taxes Payable		6,856,325

By doing this, American Greetings increases its inventory, since LIFO Reserve is a contra asset account. American Greetings also increases Retained Earnings, Income Taxes Payable, and Deferred Income Tax Payable. With one company's potential tax increase due to

[18] Bloom, Robert, and William J. Cenker. "The Death of LIFO?" *Journal of Accountancy*. Web.

changing from LIFO being over six million dollars, it is easy to see that the potential impact of forcing all companies to discontinue their use of LIFO is enormous.

With the deficit continuing to increase, the federal government is looking to raise revenues in any way that it can, which makes LIFO repeal an attractive idea. It is estimated that in 2005 the revenue that would have been made from the recapture of LIFO reserves among publicly traded companies alone would be around seventy billion dollars.[19] In 2011, that number has been estimated at greater than one hundred billion dollars. Add that to the LIFO reserves from non-publicly traded companies and revenues increase even further. In February of 2011 almost 400 companies reported a positive LIFO reserve. Exxon Mobil Corporation alone reported a LIFO reserve of twenty three billion dollars. Therefore, the one hundred billion dollar estimate may be low.[20] Obviously, the possible revenue that could be collected from a LIFO repeal would be desirable by the federal government as long as the extra income tax expenses to smaller companies did not cause many to go out of business.

This potential tax revenue has not gone unnoticed. The 2010, 2011, and 2012 federal budgets have all contained pieces leading towards LIFO reform. The 2012 budget, which was released on February 14, 2011, has proposed a LIFO repeal that would be effective for the tax year beginning after December 31, 2012. According to the 2012 budget, if LIFO were repealed, the increased tax liability would be payable over 10 years. In the 2011 budget this amount of time was only 8 years. The estimated revenue from LIFO repeal in the budget was $52.9 billion. Since the budget still has not been approved, however, it does not seem likely that this will

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[19] Kleinbard, Edward D., George A. Plesko, and Corey M. Goodman. "Is It Time to LIquidate LIFO?" *Tax Notes* (2006). *Taxanalysts.com*. Web.

[20] Ament, Joseph D. "Convergence of International Financial Reporting Standards (IFRS) and U.S. GAAP: Last-In, First-Out (LIFO) Method: Accounting and Tax Implications." Diss. Roosevelt University, 2011. Print.

happen soon. Although, the fact that a LIFO repeal was proposed does show that people are considering its viability.[21]

In deciding whether or not to repeal LIFO, congress should give adequate consideration to all of the pros and cons of its use. This decision should not be made solely for one time tax revenues attributable to the liquidation of LIFO reserves. Rather than dispose of it completely, it could hypothetically even be proposed to simply limit the use of LIFO to those companies in which it actually represents income more fairly than another form of inventory accounting. Whether from pressure to adhere to IFRS or from people believing that companies using LIFO are not paying their fair share of taxes, in the next few years this issue will have to be seriously considered and resolved.

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[21] "Obama Administration 2012 Budget Proposals." *McGladrey - Assurance, Tax and Consulting*. McGladrey and Pullen, LLP. Web. 30 Nov. 2011.

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<http://www.taxhistory.org/www/features.nsf/Articles/93826E71D9A58FB28525726B006E2140?OpenDocument>.

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