

It's Time to Get Rid of LIFO Conformity

IASB'S MOVE TO BAN LIFO DESERVES A THOUGHTFUL RESPONSE.

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Now that we're in the 21st Century, shouldn't we be uncomfortable with a significant tax provision that originated before World War II? You might think so, but the last-in, first-out (LIFO) conformity rule has been at work for so long that almost no one even notices it. We certainly have noticed, and we find that the conformity rule forces managers to shortchange stockholders in either the financial statements or the tax return. Without it, financial reporting would provide more useful information, and the economy would be more productive and prosperous.

The flaw of LIFO is its intentionally incomplete description of operating results and its long-tolerated—but misleading—description of financial position. It puts managers in a tough spot. If they want to minimize taxes by choosing LIFO, the conformity rule forces them to publish financial statements that fail to tell the complete story. If they want statements that describe the results of both inventory purchasing and marketing decisions more completely, they will choose first-in, first-out (FIFO), but only by making the corporation pay more taxes.

To eliminate this blind spot, we propose a three-phase solution. First, we would repeal the conformity rule, thereby liberating managers to make better choices. Second, we would encourage managers everywhere to implement a new inventory method that combines the advantages of FIFO and LIFO. Third, we want to promote voluntary use of replacement value accounting.

A LONG-STANDING CLASH

Public policy holds that no taxpayer should ever have to pay more than the minimum amount the law requires. Justice Learned Hand articulated this concept in an oft-cited Supreme Court case (*Commissioner v. Newman*, 47-1 USTC ¶9175) in which he declared:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.

According to this policy, taxpayers must be free to choose among available alternatives when selecting their tax-reporting practices. Because LIFO is acceptable and usually reduces tax liabilities, all taxpayers must be free to use it without adversely affecting financial reporting quality.

At the same time, the most fundamental financial reporting policy holds that companies should provide capital markets with full and fair disclosures. The idea? Informed participants will make better investment decisions and thus move the markets closer to the ultimate policy goal of smooth-running capital markets. Beginning with the Securities Act of 1933 and the Securities Exchange Act of 1934, the federal government has used mandatory financial reporting as the primary mechanism for implementing this policy.

We have no problem with either goal, yet the 1939 Congress created legislation that allows only one or the

other policy to be fulfilled. Isn't 65 years too long to tolerate this problem?

THE LIFO ELECTION

As early as 1919, the Treasury Department allowed taxpayers to use only FIFO and average cost. In the 1930s, economic turmoil created huge swings in commodity prices, thus stimulating interest in LIFO because of its potential for reducing business income taxes. LIFO works its magic by excluding from income holding gains that are realized when items are sold after their wholesale values increase above their acquisition cost. To many people, these gains are only paper profits because the seller is compelled to replace the sold units with costlier new ones. Suppose, for example, that an item is purchased for \$100, sold for \$250, and replaced for \$140. Although the total realized profit is \$150, LIFO reports only \$110, an amount that equals the net cash left over after replacing the sold goods.

Naturally, taxpayers' curiosity about LIFO grew when they learned that it might keep these gains off their tax returns. Eventually, Congress succumbed in 1939 and allowed LIFO to be applied, but only after limiting its use by writing the conformity rule into the statute. This rule requires taxpayers to use LIFO in their published financial statements if they use it on their tax returns.

While this conformity rule may have helped fill public coffers at the end of the Great Depression, it created the dysfunctional conflict between tax and financial reporting policies that still continues. Specifically, the rule coerces managers who choose LIFO for its tax savings to also deliver incomplete financial statements to the capital markets.

MEASURING THE COST AND VALUE OF GOODS SOLD

The issues related to LIFO can only be understood in the context of two broad theories about useful measures of the cost and value of goods sold: historical cost and replacement value.

Historical Cost

Under the traditional approach to financial reporting, accountants apply a cash out/cash in concept that measures the cash outflows to purchase goods against the cash inflows from their subsequent sale. Under this approach, the ideal measurement method identifies the cost of each specific item when it comes in the door and then reports that amount as the cost of goods sold when it leaves.

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is nothing but a practical compromise that fails to tell the full story about inventory management activities.

As a concession to information technology limitations of the early 20th Century, auditors allowed managers to substitute a reasonable physical inventory flow assumption in the place of more precise observations of what actually happened. Because it's common to rotate stock by selling the oldest items first, FIFO became so entrenched that it's still widely used even though the old data processing cost factors aren't as binding as they once were.

Despite its popularity, FIFO produces shortcomings in financial statements. For one, it doesn't distinguish between income from holding an item while its wholesale value increases and income from selling it at retail prices that exceed wholesale prices. The former arises through prudent purchasing and production; the latter arises through successful marketing that adds value for retail customers. (In the previous example, the holding gain is the \$40 increase in the inventory's wholesale value above the original cost of \$100, while the marketing profit is the \$110 difference between the \$250 retail price and the current wholesale value of \$140.) Although both sources of income enrich stockholders, entirely different processes created them, so it follows that detailed information about each is more useful than FIFO-based information that combines them.

The second limitation of FIFO is a balance sheet inventory description based on historical costs, not the wholesale value at the balance sheet date. (In practice, this difference may be negligible if the turnover is high.) As a consequence, the reported amount might not be useful for projecting future cash flows related to the inventory.

Replacement Value

Under the replacement value theory, accountants apply a cash in/cash out concept by comparing the cash that flows in from selling items with the cash that subsequent-

ly flows out to replace them. This approach calls for a company's income statement to report the "value of goods sold" instead of the "cost of goods sold." This deduction equals the wholesale value at the sale date, with the result that the gross margin describes only the results of the seller's marketing activity.

A full-scale replacement value implementation reports realized holding gains equal to the difference between the wholesale value at the time of sale and the original cost. In effect, replacement value accounting overcomes the first flaw of FIFO by dissecting the difference between the selling price and the original cost into its two components—marketing income and holding gains.

Perhaps unexpectedly, this theory provides a key justification for LIFO. By "matching" revenues with the most recent amounts spent on inventory, so the conventional LIFO rationale goes, the gross margin equals the marketing profit. In fact, LIFO is nothing but a practical compromise that fails to tell the full story about inventory management activities. Let's look at its four flaws.

First, it omits from income (as reported under GAAP and on tax returns) the holding gain realized when items are sold after their wholesale values increased. The acceptability of LIFO was, and still is, grounded in its favorable impact on tax liabilities rather than its theoretical merits for providing useful information to the capital markets.

Second, LIFO's allocated cost of sold goods fails to approximate replacement value if the inventory level grows. For example, if management decides to increase its physical inventory near the end of a year, LIFO causes the costs paid to accomplish that increase to flow to the income statement as if the new items had been sold instead of still being on hand. In fact, a friend of ours once had to explain to a client that its LIFO cost of goods sold included the cost of steel rolls that were en route to its factory on a ship in the middle of the Pacific because they were shipped FOB Japan.

Third, LIFO fails to report replacement value as the cost of goods sold when inventory is liquidated. For example, if management cuts its physical inventory after adopting just-in-time, LIFO forces old, even ancient, costs to flow to the income statement, thereby including in the current gross margin holding gains that were realized in prior years but not reported. In these situations, LIFO destroys the usefulness of the margin as a description of the marketing efforts while also increasing taxable income and income taxes.

Fourth, LIFO produces a totally unreliable depiction of

the company's inventory. The reported amount represents neither current replacement value nor original cost. As a compromise designed to inject some replacement value information in the financial statements, LIFO clearly leaves much to be desired.

THE THREE-PHASE SOLUTION

We think it's time for a policy change. But simply getting rid of the conformity rule isn't enough because FIFO still leaves financial statement users without full information about the results of management's purchasing and marketing activities. Our three-phase solution, however, will bring more useful information to the capital markets while preserving tax equity.

Phase One—Repeal the Conformity Rule

It's amazing that this sole instance of mandatory conformity has remained intact while the law has evolved to produce virtually complete separation between GAAP and tax-reporting choices. The complex area of interperiod tax allocation testifies to the fact that everyone has grown comfortable with the idea of the tax code and GAAP being different from each other because they serve two different purposes in two distinct arenas.

We confess that removing the conformity rule from the code won't be easy. Political pressure will be needed to get the ball rolling. The International Accounting Standards Board (IASB) has already provided one push by rendering LIFO unacceptable in public financial statements issued by companies that embrace its standards. As part of its ongoing improvements project to upgrade international standards, on December 13, 2003, the IASB issued 13 revised International Accounting Standards (IAS), including one that updated IAS 2 on inventory accounting. While this IASB decision doesn't directly impact U.S. financial reporting, it subtly pressures the Financial Accounting Standards Board (FASB) to take similar action.

Phase Two—Create New GAAP for Inventory

Because of conformity, standard setters dating back to the Committee on Accounting Procedure (CAP) have been handcuffed when it comes to improving reporting for inventories. As long ago as 1947, when the CAP issued Accounting Research Bulletin 29, "Inventory Pricing," it was constrained by conformity to providing only this vague guidance:

Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors

(such as first-in first-out, average, and last-in first-out); the major objective should be to choose the one which, under the circumstances, most clearly reflects periodic income.

As we have shown, a decision by the Committee to require FIFO would have forced managers to pay higher taxes, while a decision to require LIFO would have forced managers to publish incomplete financial statements. This same dilemma has continued, preventing both the Accounting Principles Board and the FASB from changing the status quo. Despite inventory's centrality to profitability and financial position, U.S. standard setters have been unable to shape GAAP to provide more complete and useful information. Historically, international standard setters reluctantly accepted LIFO as "an allowed alternative" to the preferred FIFO and average methods to avoid alienating U.S. constituents. Apparently, IASB's current strong desire to promote high-quality practices has finally overcome its past reluctance.

If Congress can be persuaded to repeal the conformity rule, we predict that the FASB will quickly put inventory accounting on its agenda and do away with LIFO. This action seems likely because both FASB and IASB have pledged to converge U.S. and international accounting standards. (This joint commitment, referred to informally as the "Norwalk Agreement," was announced in 2002.)

Few managers, if any, will complain about not being able to use LIFO for financial reporting. Of course, they will complain if it's taken away for tax reporting because it would cost them more and thus would defeat the purpose that made it acceptable in the first place. But if the conformity rule is repealed, we hope FASB goes further than just doing away with LIFO because FIFO, despite its advantages over LIFO, is still incomplete, especially when compared with the LIFO/FIFO method.

Combining LIFO and FIFO

We believe that one path to improved inventory reporting is a combination of LIFO and FIFO that will not only provide more information but also be easier to apply. To our knowledge, Mike Bohan and Steve Rubin first described this combination in an article in the September 1986 issue of the *Journal of Accountancy* called "LIFO/FIFO: How Would It Work?"

In simplest terms, LIFO/FIFO uses a LIFO measure in the upper income statement to estimate the replacement value of the sold goods, which is then deducted from sales to produce the gross margin from marketing activities. Next, the difference between the year's LIFO and FIFO measures of the sold goods is reported in the lower

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income statement as a realized holding gain. When this gain is combined with the marketing margin, the total equals the gross margin reported under FIFO. Finally, the LIFO/FIFO method puts the FIFO measure of ending inventory on the balance sheet. Referring to our prior example, the income statement would show a \$110 marketing profit (\$250 selling price minus the \$140 LIFO cost) and a \$40 realized gain equal to the difference between the \$140 LIFO cost of goods sold and the \$100 FIFO cost of goods sold.

In addition, this method can be applied with relatively little incremental cost. In fact, most LIFO companies already have all the information they need because they use Dollar Value LIFO techniques to convert FIFO measures taken from their internal records. For FIFO companies, the only new cost will come from applying those relatively straightforward techniques.

Yet two disadvantages remain. First, the FIFO ending inventory may not approximate the replacement value at the balance sheet date if the turnover is low. Second, problems will arise from using LIFO to approximate the wholesale value of the sold goods. As we mentioned earlier, the LIFO estimate can differ from actual replacement value if inventory levels change significantly during the year. We think standard setters can devise ways to compensate for these anomalies once they establish that the real purpose of reporting inventory events is getting complete information into the statements, not accommodating a totally obsolete provision of the tax law.

Phase Three—The Naked Truth

We believe insightful managers will begin to experiment with pure replacement value because of their dissatisfaction with compromised methods, including LIFO/FIFO.

Frankly, we just don't see many practical obstacles to

assigning current replacement values to the ending inventory. The data will be verifiable because statements are prepared long enough after the end of the reporting period to allow auditors to confirm the wholesale values at the balance sheet date by comparing them with prices from actual purchases made early in the subsequent period.

We also believe that reliable replacement values of the sold goods can be obtained. The LIFO approximation will work as long as it's adjusted to remove the effects of significant liquidations and expansions.

In addition to separately displaying the marketing profit and the realized holding gains reported under LIFO/FIFO, the pure replacement value method has the added advantage of reporting the presently unreported, unrealized holding gain from increases in wholesale values of inventory still on hand. (Unrealized holding losses are already recognized when lower-of-cost-or-market is applied.)

In effect, a pure replacement value method uses timely observations of what actually happened instead of routine assumptions about inventory flows. Reporting the naked truth may be novel, but in the wake of Enron and other scandals, we're pleased by growing support for the concept.

GETTING STARTED

As we see it, the accounting and management professions mistakenly rely on the FASB, SEC, and IRS to produce innovative methods of getting more truthful and useful information into financial statements. Accordingly, most managers will simply do nothing until they're required to change. If you're in that category, so be it. But if you want to meet the needs of financial statement users, then you should pursue alternative methods that will do a better job. You can then present this information supplementally until standard setters change GAAP to embrace these new ideas.

None of these reforms can occur, however, if Congress fails to act. Failure to repeal the rule will condemn future generations to deal with capital markets that are less efficient because of compromised and incomplete information. ■

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