# CONVERGENCE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) AND US GAAP: LAST-IN, FIRST-OUT (LIFO) METHOD: ACCOUNTING AND TAX IMPLICATIONS

**Ament, Joseph D.**

**Professor-Accounting and Taxation**

**Walter E. Heller College of Business Administration**

**Roosevelt University**

**Chicago, Illinois**

**ABSTRACT**

*FAS 157 requires firms to value all items in the financial statements at fair value. Lifo values the inventory at the oldest market prices, resulting in higher cost of goods sold and lower net income and deferred income tax liability.*

*The convergence of International Financial Reporting Standards (IFRS) and Financial Accounting Standards Board (FASB) Generally Accepted Accounting Principles (GAAP) is currently in process in regular monthly meetings with the objective of attaining a Summer 2011 deadline for resolution of all differences between International and US standards.*

*LIFO will be a major topic to be discussed and resolved because of the significant arguments of its use both for accounting and for taxation purposes.*

*Reporting cost of goods sold at fair market value would not appear to be consistent with "fair value" as set forth in FAS 157, since it would result in ending inventory being valued at historical costs, which in most situations would be substantially below current market values.*

*The Internal Revenue Code provides that to adopt LIFO as a tax accounting method, it must also be used as a financial accounting method for inventory valuation and financial statement purposes.*

*Various database information indicates that LIFO Reserves significantly exceed $100 Billion. If current US tax law were to remain in effect, a mandatory change from LIFO to a method approved by the*

*convergence, would require a payment of the deferred tax liability/reserve over a period of four years to the Internal Revenue Service, a burden most corporations could not effectively meet within the framework of their operating budgets and expected growth. A proposal would apparently be required to call upon the Congress to amend the Internal Revenue Code to permit the payment of deferred income tax liability attributable to LIFO over, say, eight to ten years. Even under that scenario many companies would be hard pressed to meet all their liquidity needs for operations, growth, current tax liabilities, and capital expenditures. Certain industries have particularly benefitted by LIFO reserves and postponement of tax liabilities, such as the oil, petroleum and other natural resources, distilleries and other long-term assets held in inventory.*

*Major financial sources would be called upon in the banking and related industries to assist entities by lending to them and/or developing an equity stake in their businesses to provide substantial tax payments as a result of the termination of the LIFO method for accounting and tax purposes.*

## INTRODUCTION

More than one hundred billion ($100B) dollars is estimated by various sources as the current dollar amount of deferrals/LIFO reserves due to the use of last-in, first-out (LIFO) as the accounting method used for inventory valuation.

In order to understand certain basic aspects that relate to LIFO, some terminology should be explained as it will be used in the context of this presentation. An assumption is made, when LIFO is used, that goods sold are those purchased most recently and that goods remaining in inventory at the end of the period that the company purchased since it adopted LIFO, in order of its purchase, earliest first and most recent last. The reason that this method is used is the matching of revenues (merchandise sold) during the most recent accounting period with the most recent purchase costs of goods acquired. Using LIFO in times of increasing prices creates an effect by which the value of the most recently purchased, highest costs merchandise, when compared to other inventory valuation methods, such as first-in, first-out (FIFO) and average cost, is that higher cost items are included in the cost of goods sold, while the older, lower cost merchandise will remain valued in inventory. The bottom line effect of utilizing LIFO therefore is a lower inventory valuation, a higher cost of goods sold calculation and lower net and taxable income.

Another way to analyze the effects of LIFO would be that in inflationary periods, LIFO shifts the rising price impact from inventory valuation in the balance sheet to cost of goods sold in the income statement, resulting in lower net income and therefore lower income tax liability.

The U.S. Treasury Department permits a simplified method of calculating LIFO, whereby the Inventory Price Index Computation (IPIC) method permits taxpayers to use published U.S. government inflation indexes to calculate inflation for purposes of valuing LIFO inventories. These external indexes and the application of this method are permitted in Internal Revenue Code (IRC) regulations (Reg.) Section 1.472-8(e).

Many large corporations use LIFO, particularly those in the natural resources industries, such as oil and gas. Billions of dollars of income tax have been deferred by these huge public companies.

However, also US small businesses will be greatly impacted, if the U.S. Congress repeals or restricts the use of the LIFO inventory accounting method under U.S. tax laws, which is currently being proposed by the Obama administration and is being considered by the Congress.

Arguments are made that foreign competition would have a substantial advantage over U.S. companies in the market place, if LIFO were not permitted to be elected. Some industries, by their nature, have to hold their inventory for a long time. Using LIFO would be a reasonable and fair manner to recognize the special problems that these businesses would have with their non-U.S. competitors.

In addition to the explanation of LIFO and the impact inflationary increase in prices has in regard to the pricing of inventories, cost of goods sold and met/taxable income, the LIFO method is also important to companies that maintain large inventories over a period of several years, such as distilleries, wineries, and other businesses that must age their inventories. Mandatory changing from LIFO to FIFO would have the effect of giving those types of companies income on which they would have to pay taxes, even though the merchandise they have placed into inventory may not be available for sale, because of the necessity to age, for numerous years.

It is not only the distilleries, wineries, natural resources (oil, gas, etc.) and similar industries that would be impacted, but also any other business that retains inventory for long periods of time, such as the aero space industry and other very high priced production.

The purchase of inventory represents an exchange of cash for an equal value of assets. However, an entity cannot deduct inventory, when it is purchased. The deduction is taken by companies for the cost of inventory that has been disposed of as reflected in the cost of goods sold, as a deduction against revenue in computing net profit.

Depending upon the dates when inventory was purchased, similar merchandise which is in the entities' operational process and accounting for inventory, may have different costs assigned to them (even for similar, if not identical, goods) depending on various factors including the time when they were purchased, the methods that have been adopted, and whether the costs have been properly accounted for as a product cost or as a period cost, in order to determine cost of goods sold, which will be deducted from sales revenue, in arriving at net income and taxable income.

LIFO is unique in its application, since companies can elect to use the method as long as they use it for both financial statement purposes and for income taxation purposes. Another way to describe LIFO is that this method assumes that the first purchased goods make up the entities' inventory at the close of the year. As stated before, if prices are rising (i.e. inflationary), LIFO allocates higher costs to sold merchandise, which reduces current income (for both financial and tax purposes) and calculates a lower value to the inventory at the end of the accounting period.

The principal topic of this presentation is focused on convergence of IFRS and GAAP, their accounting and tax implications pertaining to LIFO.

However, the negotiations currently taking place between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to accomplish the merger of accounting rules, regulations, policies and standards by the international governing body and the U.S. governing body, and the announcement by the U.S. Securities and Exchange Commission in August 2008 to accomplish the convergence with a deadline of 2014, with some aspects to occur in 2011, has brought this topic not only to financial awareness, but also the political and legislative implications as well, since LIFO is one of the specific topics that impacts financial reporting and taxation simultaneously.

The convergence combined with the announcement of the SEC focused on the deferred U.S. income tax of those corporations that have elected LIFO.

Considering the economic circumstances that have occurred in the past more than two years and their major effect on the economy, tax collections, and the U.S. deficit, presented an opportunity for the Obama administration and their budget to propose to the Congress a repeal of the election to use LIFO for income tax purposes.

Currently electing taxpayers that use the LIFO method would, under the pending budget proposal, be required to revalue their beginning LIFO inventory to FIFO value in the first taxable year beginning after December 31, 2011. This one time increase in gross income by revaluing inventory from LIFO to FIFO would be taken into account ratably over the first taxable year and the following seven taxable years. Therefore, over a period of eight years, corporations would have to increase their federal income tax liability (and probably state income tax liability) by one-eighth (12½%) of the deferred income tax liability as of December 31, 2011.

To estimate, for example, if the deferred U.S. Income Tax Liability exceeds one hundred billion dollars currently, this would mean, using those assumed figures, that corporations would have to do their corporate planning to have at least Twelve Billion Five Hundred Million ($12.5B) Dollars each year available for additional income tax in their cash budget, if not more.

There are various arguments among persons that are for and those that are against what repeal of LIFO may effectuate, particularly from a tax standpoint. Those in favor of a repeal argue that LIFO has no value as a management tool and serves only to cut tax liability for a relatively small number of companies. Those against repeal argue that LIFO makes the effective tax rate on inventory comparable to that on machinery, equipment, buildings and other depreciable assets and that repeal would overtax inventory. In addition, they believe that in the presence of inflation, FIFO taxes firms on profits that represent changes in the price level instead of low economic profits and that LIFO may represent a better approximation of real economic income. Finally, those who are in favor of a repeal point out that LIFO is not permitted under the International Financial Reporting Standards (IFRS).

From a political standpoint, the Congress and the Obama administration are being pressed by the large budget deficit and the need to obtain more resources to meet the ever increasing negative impact of these problems and the economy. Convergence of IFRS and GAAP, give a big advantage in the political sphere, since the executive and legislative branches of government can say that this issue was brought to them from outside sources, namely corporations in foreign countries, who want to list their securities on American exchanges. Currently, their financial statements are prepared using IFRS, which has not been acceptable to the U.S. Securities and Exchange Commission, since the financial statements are not prepared in accordance with requirements of the Financial Accounting Standards Board (FASB) and generally accepted accounting principles (GAAP).

For reasons related to the desire to have United States securities and other exchanges be more open to the global economy, the IFRS provisions require many modifications in U.S. accounting practices. LIFO is one of those methods not permitted by IFRS. Both United States accounting provisions as well as United States tax law require that LIFO is necessary to be used for both financial and tax reporting purposes, if a company elects to use LIFO.

Congress may use LIFO repeal to offset the costs of some pending tax incentives, such as the package of tax extenders that has been before Congress, or to meet other major budget deficits attributable to adverse economic conditions.

On August 2, 2010, the Committee on Taxation of Financial Executives International (FEI) sent a letter, executed by the Committee's Chairman, Ron Dickel, addressed to Jeffrey Minton, Chief Counsel, Office of Chief Accountant, Securities and Exchange Commission, also sent to Heather Maloy, Commissioner, Internal Revenue Service Large and Mid-Size Business Division, with various suggestions of the FEI Committee on Taxation. The letter requested consideration of guidance on transfer pricing, inventory accounting, and other related topics, as well as weighing new policies to respond to major tax-related changes presented by a potential shift to International Financial Reporting Standards.

The FEI Taxation Committee letter not only focused on how major inventory accounting changes from an adoption of IFRS, such as an inability to use LIFO, would affect taxes by U.S. companies, but indicated that was only one situation that should be considered. The shift in permissible accounting inventory methods would concurrently "surrender a potentially significant tax benefit that may have accrued over an extended period of time".

Mr. Dickel commented on several of the topics we have already discussed hereinabove in this paper, but, in addition, his committee also focused on existing transfer pricing policies and documentation and how the use of IFRS will probably affect those organizations.

Another topic raised by the FEI Committee dealt with the process of conversion from LIFO to IFRS and whether IRS consent must be obtained by filing Form 3115-Application for Change in Accounting Method, and if so, the need for issuance of guidance to limit taxpayer and IRS burdens in filing and reviewing "what would otherwise be significant numbers of Forms 3115 arising from IFRS conversions", which would in effect not be elective in this situation, but mandatory based upon the action of the FASB, the IASB, and the Congress through the changing of accounting rules and regulations and tax law.

The final point made by the FEI dealt with potential reconciliation requirements between U.S. GAAP and IFRS upon a conversion to IFRS and a balancing of the benefit versus the burden associated with creating such a reconciliation.

Some of the corporations that report their inventories in total or in part using LIFO include Exxon Mobil Corporation, Chevron, Sherwin-Williams Company, Curtiss-Wright Corporation, Ford Motor Company, Conoco Phillips Co., Fortune Brands, Inc. and many other significant corporations.

Exxon Mobil Corporation stands out as a corporation that benefits from electing LIFO, since at December 31, 2009, its balance sheet indicates that deferred income tax liabilities exceed Twenty Three Billion ($23B) Dollars.

Another corporation with substantial inventories using the LIFO method is Chevron Corporation which reports that at December 31, 2009 its total inventories of crude oil and petroleum products and chemicals using a LIFO method, total Four Billion Sixty-Three Million ($4.63B) Dollars. Many other corporations use LIFO either in total or in part in valuation of their inventories and determination of their LIFO reserves and deferred income tax liabilities.

Approximately 400 companies report a positive LIFO reserve, therefore, if only one of these companies, Exxon Mobil Corporation exceeds Twenty Three Billion ($23B) Dollars, perhaps the One Hundred Billion ($100B) Dollars total estimate is modest.

**INDUSTRY SURVEY**

The Construction Equipment Distributors Industry did a survey about the use of LIFO last year through information obtained from Associated Equipment Distributors.

The survey concluded that LIFO repeal would hit the numbers of the industry adversely. It confirmed prior analysis about the impact that repealing LIFO would have on the equipment industry. Consistent with previous surveys, thirty-three (33%) percent of respondents reported using LIFO to value their inventories (33% used FIFO, 26% used average cost, and 8% report using some other accounting method). Sixty (60%) percent of LIFO users have more than 100 employees and sixty-three (63%)

percent have more than 75 million dollars in annual revenues. LIFO is a well established accounting method in this industry. Seventy-seven (77%) percent of companies using LIFO have done so for more than 20 years, and forty-nine (49%) percent have used LIFO for more than 30 years.

The average reported LIFO reserve of survey respondents using LIFO was Fourteen Billion ($14B) Dollars in early 2009. From this number, it was estimated that the members collectively have $2.8 billion dollars in combined LIFO reserves and repeal would cost equipment distributors more than $900 million dollars in retroactive tax liability as of early 2009. It can therefore be assumed that this figure would be close to One Billion ($1B) Dollars by the end of 2010. Finally, the survey in early 2009 also illustrates the wide-ranging impact LIFO repeal would have on distributors and their employees in this industry. Thirty-four (34%) percent of LIFO users said that they would have to lay off workers or eliminate positions, if LIFO were repealed; thirty-seven (37%) percent said that they would have to reduce benefits, including health insurance; fifty-four (54%) percent said they would be less likely to invest in new technology and equipment; sixty-nine (69%) percent said that they would be less likely to expand their rental fleets; and thirty-four (34%) percent said LIFO repeal would threaten their company's ability to survive in the current economic environment.

## CONCLUSION

Many persons have taken the position that of all of the issues that challenge the convergence of IFRS and GAAP, the fact that IFRS does not recognize the LIFO method is the most significant, since the prohibition of public companies from using LIFO creates both a financial statement and an income tax set of consequences which not only requires the approval and action of the Financial Accounting Standards Board (FASB) in the United States but also changes in the U.S. tax law by Congress.

Unless the Internal Revenue Code is amended in several respects, these public companies could no longer use LIFO for U.S. income tax purposes. Potentially there would be a very large increase in income tax payments that are currently deferred.

In any event, the current law, permitting in many circumstances a four year allocation of the payment of deferred income tax liability, if the LIFO method were terminated, would necessitate being extended to possibly eight to ten years, if not longer, in order to realistically lighten the financial burden on companies making this change, since they most likely would not have the economic resources, particularly cash, available to meet their current working capital and property, plant and equipment replacement and expansion needs and also to fulfill the payment of deferred income tax liabilities.

Perhaps another solution to this conundrum might be to permit United States based corporations, at their discretion, to prepare financial statements using both GAAP and IFRS, with a reconciling schedule explaining the differences in various material accounts, and continue to use LIFO for GAAP and income tax purposes. Although this would be more costly to maintain and to audit, it may provide a resolution acceptable to those corporations who would be adversely impacted by the mandatory change, if LIFO were totally eliminated.

A survey by the American Institute of Certified Public Accountants (AICPA) in 2008 found 36% of U.S. firms use LIFO for at least some of their inventory accounting. Many professionals and academics believe that LIFO offers a more accurate picture of profits by aligning costs with revenues. As stated hereinabove, LIFO accounting is suited to periods of inflation. If deflation should occur (which many economists and other financial authorities have been conjecturing in these difficult financial times), abolishing LIFO for companies that benefitted by it during the inflationary/boom years, would actually enjoy a tax shield on future profits from the new accounting method that would replace LIFO. Such a policy outcome, could be attributable to unintended consequences of terminating the LIFO method.

It is also argued that having two sets of accounting principles or standards, GAAP and IFRS, creates a healthy competitive global atmosphere, where each group is focused on what the other group is doing and this, in turn, can attain the best accounting rules, regulations, standards, and financial data presentation. Unifying all of the data into one system may dilute the benefits of competitive qualities.

**REFERENCE SOURCES**


1. LIFO Reserve information from Compustat Data Base and CCH Standard Federal Tax Reports-Taxes on Parade 9-9-10 Comment to LTR 201034004.

2. LIFO Pro Glossary of LIFO related terms.

3. Tax Policy Center – Urban Institute and Brookings Institution – 2010 Budget – Repeal LIFO.

4. Internal Revenue Code Regulations 1.472-8(e).

5. The New Accountant – Oct. 2010 – International Financial Reporting Standards: Major Changes to U.S. Financial Reporting on the Way (by Donald Samelson, Morgan Pride and Jeffrey Casterella).

6. WIPFLI.COM – The Death of LIFO? February 25, 2009.

7. BNA Daily Tax Report – August 6, 2010 – G5-6 – Financial Executives International Committee on Taxation.

8. 2009 Annual Reports –
   Exxon Mobil Corporation
   Ford Motor Company
   Sherwin-Williams Company
   Conoco Phillips Co.
   Chevron Corporation
   Curtiss-Wright Corporation
   Fortune Brands, Inc.

9. Associated Equipment Distributors Survey regarding LIFO repeal impact on equipment industry – 2009.

10. Wall Street Journal – Firms Might Need A LIFO Preserver – Thursday, December 2, 2010, Page C12.