

IFRS And US GAAP Convergence Progressing: As Taxpayers Voluntarily Stop Using LIFO

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ABSTRACT

This paper presents the potential benefits of the last in, first out (LIFO) inventory valuation method being eliminated as a requirement in financial statements prepared under United States Generally Accepted Accounting Principles when also used for United States federal income tax reporting. Research results show that corporations have been voluntarily switching from LIFO to another method since inflation declined well below double digits. Of the corporations still using LIFO, the potential billions of federal tax revenue is presented that might help keep the United States federal budget from going over the fiscal cliff.

Keywords: Inventory; Taxation; GAAP; IFRS; LIFO; Convergence

INTRODUCTION

A brief history of last in, first out (LIFO) is presented first to provide a context of the issue and the International Accounting Standards Board (IASB) prohibition of LIFO is presented next. The link between United States (US) federal tax law and US Generally Accepted Accounting Principles (GAAP) regarding LIFO is then presented with a discussion of deferred taxes and potential federal tax revenue. Then entities voluntarily changing from LIFO to another inventory method are discussed, with potential research noted before the conclusion.

HISTORY

For a detailed history of the LIFO method, see the work of Fosbre, Fosbre and Kraft (2010). The following brief summary in this paragraph is based on the Fosbre et al. article. The LIFO method evolved from the base-stock inventory method used in England in the 1880s. The base-stock method was used by taxpayers in England and the US to minimize taxes paid. In 1918, England banned the use of the base-stock method, followed by the US banning it in 1919. The US allowed the use of LIFO beginning in 1938 in response to the Great Depression. The express purpose of LIFO was to allow taxpayers to pay less tax.

The LIFO inventory measurement method gained appeal in the US when inflation was in the double digits (e.g., 1970s) and inventory on-hand was ample. Since the beginning of the 21st century, LIFO has lost appeal due to technological increases and inflation decreases. The technological advances have resulted in inventory management systems, such as Just-In-Time (JIT) and Lean Accounting, which allowed smaller amounts of inventory to be stored on site. The Consumer-Price-Index (CPI) indicates that inflation was small and occasionally negative during the last several years (US DoL BLS, 2012). The fair market value (FMV) of inventory has tended to be stable since the beginning of the 21st century. This is not to disregard the supply and demand impact on inventory values.

After over 70 years of LIFO being allowed for federal tax purposes, President Barack Obama's fiscal budget has included a proposal that the LIFO method be disallowed. The proposal was defeated with each attempt prior to fiscal year 2013. However, the proposed budget for fiscal year 2013 again includes disallowing LIFO for federal income tax preparation. The proposed elimination from financial accounting reporting is discussed next.

IASB & US FEDERAL LAW

The IASB does not allow LIFO as noted in the International Financial Reporting Standards (IFRS). President Barack Obama's proposed budget for fiscal year 2013 included the elimination of LIFO for US federal tax reports beginning with tax years after December 31, 2013. He has made this proposal before without success. Prior proposals did not contain the 10-year allocation period that was included in the proposal made in 2012. Prior law and proposals allowed less than ten years (e.g., four years). The pressure of the IASB and President Obama could result in LIFO being eliminated and/or significantly limited.

4 TO 10 YEARS

For corporations changing from LIFO to another inventory valuation method, the biggest obstacle has been the potential resulting tax bill. The House Ways and Means Committee estimated that for companies to switch from LIFO to another inventory valuation method would "raise approximately \$106 billion over ten years" (Hoffman & McKenzie, 2009). Much has been written about how companies can and should treat the changeover from LIFO to another method. However, neither US GAAP nor IFRS have statutory enforcement mechanisms. The Internal Revenue Code (IRC), on the other hand, does have such authority. Section 472(c) of the Code specifies that "taxpayers who apply LIFO for tax purposes [must also] apply it for income measurement in financial reporting." It does not outlaw LIFO (IRC, 2012). A challenge for companies would be to take advantage of the favorable tax treatment of LIFO without violating the principles of IFRS. That challenge could be met in more than one way. The regulations under IRC section 472 add much to the proper understanding of how to apply the law. The regulations state that supplemental information presented in the notes, or anywhere except in the body of the financial statements of "non-LIFO inventory valuations, will not violate the LIFO conformity requirement" (Hoffman & McKenzie, 2009). This would presumably satisfy the requirements of IFRS as well as the Internal Revenue Service (IRS) and allow companies to continue to take advantage of LIFO. Another way to meet the challenge is to prepare two sets of reports - one using LIFO and another inventory valuation method. It seems unlikely that companies will passively relinquish profit to the tune of \$106 billion just because an international body, with no enforcement authority, says they do not allow LIFO as an inventory valuation method.

Deferred taxes could be reduced and taxes payable increased if President Obama's proposed changes are implemented. President Obama proposed that the inventory valuation method of LIFO be eliminated as an option for US federal income tax reporting (DOT, 2012, p 131). President Obama also proposed that the inventory method of lower-of-cost-or market (LCM) be changed (DOT, p. 132). These would be effective for tax years beginning after December 31, 2013. To ease the cash flow from the taxed organizations to the federal government, the payments can be spread over 10 years (DOT, pp. 131-132). In essence, this component of the deferred tax process would be phased out over 10 years, which substantially expands the number of years currently specified in IRC section 481 (IRC, 2012).

POTENTIAL FEDERAL TAX REVENUE

To illustrate the potential federal tax revenue, Wal-Mart reports that LIFO is used (Wal-Mart, 2012, p. 29). The deferred tax related to inventories increased from \$1,014,000,000 for 2011 to \$1,627,000,000 for 2012 (p. 48). If LIFO had been eliminated effective for tax years after December 31, 2011, then the fiscal cliff could have been lowered by \$613 million from Wal-Mart alone. If one-tenth of the existing balance of \$1,014,000,000 was also added to \$613,000, then the US federal government could have received \$714.4 million from just one corporation. The US Chamber of Commerce (US CoC, 2012) estimated that the repeal of LIFO would generate \$56 billion in federal tax revenues. The US Chamber of Commerce (2012) predicted that the "repeal of the lower-of-cost-or-market (LCM) and subnormal goods accounting methods [would] ... raise \$8 billion" in federal tax revenues. This suggests that \$64 billion in federal tax revenues could be raised to possibly help lower the "fiscal cliff" referenced regularly toward the end of the year 2012.

While the US federal government can see the potential revenue benefit, the corporate concern is the potential cash outflow requirement for federal tax payable. If LIFO is eliminated, then retrospective application for financial reporting is required under the Financial Accounting Standards Board (FASB) accounting standards

codification (ASC) 250-10-50. Huguen, Livingstone and Upton (2011) analyzed the potential impact using tax rates from the years 1990-2008. The retrospective application would potentially generate a large tax bill due to the resulting increase in net income.

Prior to the proposed fiscal year 2013 US federal budget changes, corporations were able to allocate the tax expense over the course of four years, starting with the year the change was made (Bloom & Cenker, 2009), to overcome the tax hurdle caused by the restatement of past statements using the first in, first out (FIFO) or weighted average methods of inventory measurement. This is done with the use of a Deferred Tax Liability account. President Obama’s proposed fiscal year 2013 budget extended the time periods from four to 10 years (DOT, 2012).

Switching from the LIFO method to another inventory valuation method will have an impact on the financial statements and tax reports prepared by corporations. The financial statements for corporations switching off LIFO are expected to show higher taxable income. These increases in taxable income will present better financial results for the company increasing opportunity for credit and growth (Fosbre, Fosbre & Kraft, 2010). Switching from LIFO will increase income tax liability because valuation methods, such as FIFO, typically result in higher ending inventory and lower cost of goods sold, which increases income and taxes (Jeffers & Askew, 2010).

If the US income tax law is changed so that inventory methods do not have to be the same in income tax statements and financial statements, then converging IFRS and US GAAP would not be so controversial. The change from one inventory method to another for financial statements could change reported net income without there being a federal income tax cash flow impact.

ENTITIES VOLUNTARILY CHANGING FROM LIFO

As of the year 2011, only 312 entities used LIFO as compared to 325 in the year 2009 (AICPA, 2012, p. 192). Of these entities, four used only LIFO for inventory (AICPA, 2012, p. 193). Only 66 entities in the year 2011 used LIFO for 50% or more of inventories as compared to 82 corporations in the year 2009 (Ibid.). Huguen, Livingston and Upton (2011) reported that 449 entities used LIFO in the year 2004 as compared to 339 in the year 2008 (p. 26). The absolute numbers are summarized in Table 1. The decline is even more dramatic when considering that while entities are using LIFO, they are using LIFO for a declining percentage of total inventory.

Table 1: Voluntary Decline In Use Of LIFO

Year	2011	2008	2009	2004
Number of entities using LIFO under US GAAP	312	339	325	449

Huguen et al. reported a steady percentage decline from 2004 through 2008 of entities using LIFO (p. 27). The percentages were as follows for the years 2004 through 2008, respectively: 7.91%, 7.65%, 7.56%, 7.28% and 7.09% (p. 27). This steady decline in the percentage of entities using LIFO indicates that banning LIFO will be more easily implemented.

Fosbre, Fosbre and Kraft (2010) reported that the petroleum refining companies have the highest potential increase in taxes due to the switch from LIFO to another inventory method. They explicitly noted the following four entities: Exxon Mobile, Marathon Oil Corporation, Valero Energy Corporation and Sunoco. “The majority of [Marathon Oil Corporation (2012)] ... inventories are recorded at average cost” (p. 61). This indicates that Marathon Oil Corporation voluntarily changed from primarily using LIFO to primarily using average cost. “The LIFO method accounted for 16 percent and 85 percent of total inventory value on December 31, 2011 and 2010, respectively.” (p. 75) Exxon (2012) uses LIFO (p. F-28), Valero Energy Corporation (2012) uses LIFO (p. 54), and Sunoco (2012) uses LIFO (p. 52). There is no explicit disclosure in the annual reports for calendar year ending December 31, 2011 that addresses the impact of LIFO on Deferred Taxes for these three entities. On the other hand, Wal-Mart is an example of an entity that used LIFO and disclosed the impact on deferred taxes as discussed above.

FUTURE RESEARCH

Future research could expand into the lower of cost or market (LCM) differences between IFRS and US GAAP regarding inventory. While both IFRS and US GAAP allow writing down to the LCM, US GAAP does not allow writing back up to cost after inventory has been written down per LCM. When the write-down reverses, the organizations are to write inventory back up to cost per IFRS. The IFRS approach has the potential of increasing earnings volatility, which most organizations do not prefer. “Under IFRS, companies might experience greater earnings volatility in relation to recoveries in values previously written down ... Reversals of inventory write-downs (limited to the amount of the original write-down) are required for subsequent recoveries ... [whereas] reversals of write-downs are prohibited” under US GAAP (PwC, 2012, p. 82).

Related to the volatility concern could be the debt to equity ratio. If there are existing debt covenants similar to those that existed in the real estate industry when fair market value (FMV) accounting adversely impacted the debt to equity ratio, then there may be additional concerns. There are additional possible research extensions, but two are most relevant - LCM loss reversals and potential earnings volatility.

CONCLUSIONS

The LIFO method is steadily disappearing from US financial reports. The road block to convergence, due to the IFRS mandate that LIFO not be used and the US IRS tax law that LIFO must be used for financial reports when used for tax report, is shrinking to being a speed bump. This indicates that IFRS and US GAAP are progressing toward convergence without a mandate from the SEC. Once a significant majority of US corporations switch from LIFO for tax reports, the FASB can then promulgate an accounting requirement that LIFO not be used for financial reports. The FASB promulgations cause less controversy when they describe existing practice versus setting normative standards. Progress is being made toward convergence.

AUTHOR INFORMATION

Dahli Gray earned her doctoral degree from the George Washington University. She has over 40 articles published in journals such as *Journal of Accounting Research* and the *Journal of Accountancy*. She has made over 60 professional presentations at American Accounting Association meetings and at conferences in the United States and other countries, such as Japan. She has been full-time faculty at schools such as the University of Notre Dame and American University. In addition to being a Contributing Faculty member with Walden University, she is a CPA, CMA and Certified Fraud Examiner with her consulting firm. E-mail: dahli.gray@waldenu.edu

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