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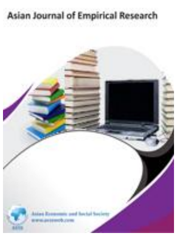

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THE POSITIVE FUTURE OUTLOOK OF THE LAST IN FIRST OUT INVENTORY METHODS

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ABSTRACT

The Last in First out Method (LIFO) is presently under severe scrutiny from the financial community, which may soon culminate in its repeal as an acceptable accounting method. There are pressures from the International Financial Accounting Standards Board to standardize accounting standards worldwide. In addition, there is political pressure imposed by US Congress to raise additional revenues.Both groups strongly oppose LIFO, raising the possibility of its complete elimination as an acceptable accounting method. However, adverse economic and political events in 2011 and again in 2012 have greatly renewed the lifeline of LIFO indefinitely. In the unlikely case of its ultimate repeal, the author presents some tax opportunities available in this transition period.

Keywords:LIFO, LIFO Reserve, IFRS, US GAAP, FIFO.

INTRODUCTION

The Last in First out (LIFO) method has been an acceptable, popular accounting method since its inception in 1939. Since then, many have and continue to argue against LIFO as a viable, economic accounting method. At present, LIFO faces a possibility of its elimination by the year 2015, as political forces coming from the International Financial Accounting Standards Board, the world financial community and the US administration strongly oppose this method. The International Financial Reporting Standards (IFRS) prohibits LIFO as an acceptable accounting method, and the Obama administration proposed in its 2010 budget to repeal LIFO altogether in the future. However, given new developments against Senator Rangel, LIFO's biggest critic and the renewed worldwide recession, as well as an unprecedented report by the SEC, which not avoided a critical due date of convergence ,but questioned IFRS use altogether, LIFO’s repeal is now very unlikely. Part 2 will give a literature review of LIFO’s tax advantages and financial statement limitations. Part 3 will examine the current state of LIFO, and Part 4 will investigate the future of LIFO, while Part 5 will provide recommended tax planning opportunities assuming the possible repeal of LIFO. The conclusion section Part 6, will also recommend areas for future research.

LITERATURE REVIEW

The tax advantages associated with LIFO have been documented by tax laws, research, literature and Congress. Internal Revenue Code (IRC) 472 allows for the Last in First Out method of inventory since its inception date in 1939. Computationally, as the price of inventory increases,

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lower income will result under LIFO when compared to all other inventory methods, resulting in a lower tax payment. This tax advantage has led to the criticism of LIFO resulting in an unfair tax loophole advantage for a few beneficial industries, leading to poor and inefficient management of inventories and finally flawing the balance sheet presentation.

While, White, Sondhi and Fried (2008), state that due to the tax advantages associated with LIFO resulting in greater cash flows, the choice of inventory method should point towards LIFO. Dopuch and Pincur (1988) found that the taxation effect was the primary reason a company chose LIFO.To obtain the tax benefit, three elements have to be satisfied. First, increasing inventory prices and second, a buildup or increase in inventory, known as a LIFO reserve and finally, there has to be an income tax. LIFO uses in an inflationary environment will result in expensing the most current higher cost inventory purchases against revenue, resulting in the lowest possible income total. The greater the inflation environment, the more pronounced is the tax benefit. This was observed in the early to mid-1970, a period of double digit inflation in the U.S, when more than 400 publically U.S companies elected to change their inventory method to LIFO. These were the companies who can benefit from LIFO use.

The tax advantages of LIFO are dependent on inventory additions or buildups, known as reserves at increasing prices. This has resulted in poor inventory asset management and suboptimal business behavior as observed by Trackel and Trezevant (1994).The US government has estimated that presently less than 5% of publically traded companies use LIFO, and that the corporate tax rate of 35% can be reduced to 30.5% if all of the corporate tax loopholes such as LIFO were eliminated. The elimination of LIFO is expected to add 100 billion dollars in US tax revenue over the next ten years according to Senator Rangel. This figure is very optimistic and inflated when one considers that the overall LIFO reserve is 100 billion dollars (Compustat), so at a 35% tax rate , this LIFO reserve figure will have to triple over the next ten years to meet the projections of the Senator. A more realistic figure will be 35 million dollars added to tax revenue to the US government over an eight year period.

As a defense to LIFO users, non LIFO firms have the option to adapt the Lower of Cost or Market Method (LCM). LCM allows inventory to be valued below cost if cost exceeds market value. Market value is defined as replacement cost and such valuation can be made on an item by item basis. As an example, a company may use and to take a tax advantage prior to sale by the use of non LIFO LCM method. Given that LIFO adopters tend to experience increasing inventory market values, this benefit is not really viable. Additionally, I believe pressures in the future by Congress will eliminate this potential advantage if LIFO is repealed, as it represents yet another tax loophole, primarily for non LIFO users. This method is used by industries which have obsolete type inventories like computer, chip and food.

The tax deferred argument under FASB 109 can be made in defense of LIFO. One may argue that this LIFO reserve represents a temporary tax difference, which will be paid to the US government in the future, when this difference reverses causing higher taxable income. This is no different than differences resulting in depreciation between book and tax purposes, which leads to a high deferred tax liability. This is defended on the grounds that it results in greater economic growth and is a good policy undertaken by the regulators. Eliminating LIFO and other FASB 109 items will disrupt the economy. A comprehensive tax plan should be addressed, which has been talked about by political leaders as a need to a fair tax which has been and continues to be opposed by special interest groups, rather than an attempted micromanagement of tax policy.

Finally, one needs to question whether the elimination of LIFO will have any dent on the federal deficit which at present is 16 trillion dollars, and regulators calling for more money to spur the economy. The federal debt ceiling has just recently increased by over 2 trillion dollars causing Standard and Poor's have to reduce the rating of the US Government bonds from AAA to AA.

Repealing LIFO will add per my projection, 35 billion in tax revenue which will reduce the deficit a meager one quarter of one percent. LIFO is not in any way the culprit of this deficit, and the regulators realize this as they have eased their attack on LIFO in this most recent time.

CURRENT STATE OF LIFO

LIFO wasfacing pressures from both: the International Reporting Standards Board in cooperation with the SEC and the U.S. Congress for its possible complete elimination by the year 2014.On November 15, 2007, the Securities and Exchange Commission (SEC) exempted foreign firms from including reconciliation from International Financial Reporting Standards (IFRS) to U.S Generally Accepted Accounting Principles, (U.S. GAAP) when filing on U.S Stock exchanges. Foreign public firms are now permitted to file using the International Financial Reporting Standards (IFRS) without reconciliation to U.S GAAP as previously required. This move has created a mandate to converge IFRS and U.S GAAP and financial statement requirements (SEC, 2007).

On June, 18, 2008 the SEC issued a press release stating that the world's securities regulators are uniting to increase their oversight of international accounting standards. There are plans set forth by the SEC and the IFRS to standardize accounting standards, on a worldwide basis with a target date set for periods ending after December 31, 2014. Under IFRS rules, LIFO is not a permitted acceptable accounting method. IFRS is balance sheet oriented and on this basis, disallows LIFO as an inventory method. The use of LIFO disrupts the theoretical foundation of the IFRS. More importantly is the current tax position on LIFO. The Obama administration has proposed in its 2010 budget to repeal LIFO altogether in an attempt to generate greater tax revenues.

Recently in 2010, Senator Rangel, the biggest political critic of LIFO was brought up on a number of ethical violations. This in effect has pushed LIFO repeal backwards and has at best delayed its possible repeal. Additionally, the economic crisis has resumed unexpectedly in 2011 as the pale state of the economy was announced, which was contrary to the belief that it was in a recovery stage. Most significantly in 2012, the SEC announced that it has no target date, if any, for IFRS convergence in the U.S and expressed major constraints if plans for convergence were to continue. Clearly, the SEC is in no rush and non-enthusiastic about convergence, which is not likely to happen anytime in the intermediate future. These developments have put LIFO repeal on the backburner and the result is that the political pressures against LIFO have eased in a significant manner and the likelihood of its eventual repeal now is very unlikely.

THE FUTURE OF LIFO

There are four possibilities of LIFO going forward, and illustrated as follows:

Case	Financial Reporting Purposes	Tax Purposes
1	Yes	Yes
2	No	Yes
3	Yes	No
4	No	No

In case 1, LIFO would continue as present. Although dual resistance from IFRS and Congress exist, recent developments and charges against senator Rangel coupled with the continued weakness in the worldwide economy makes the status quo a reality. Although the continued use of LIFO will greatly and potentially hinder the goal of uniform financial reporting going forward, the ultimate goal here has moved to convergence and not uniformity, adding to the real probability of continued LIFO use in the U.S. Compromises between U.S GAAP and IFRS in my opinion will be the norm rather than the exception going forward.

In case 2, allowing LIFO for tax purposes and not for financial reporting purchases represents the best of both world, as a company report the highest income for financial reporting purposes and pay the least amount of tax. The scenario would effectively eliminate the LIFO conformity requirement. The likelihood of this happening is most unlikely and not feasible.In case 3, the worst of both worlds for a company; that is, the lowest income for financial reporting and the highest tax payment. This scenario is also not feasible.

Case 4 represents the complete elimination of LIFO. This will only occur if LIFO is eliminated at the tax level. If so, then it will be eliminated for financial reporting purposes, as the advantage for business purposes would not exist. Given the SEC's non commitment to IFRS adaption in the US, the spiraling US deficit which now exceeds 16 trillion dollars, LIFO is safe and unlikely that any repeal will occur in the future. In addition, the continuing worldwide economic problems, LIFO at this time is just a footnote for the US regulators, similar to the second term of then President Bush, which leads me to predict that this issue will not be addressed well beyond the 2012 election. My prediction then is a status quo on LIFO at this time and in the near foreseeable future.

TAX PLANNING OPPORTUNITIES AVAILABLE FOR THE CURRENT USERS OF LIFO

Assuming the repeal of LIFO which I believe is unlikely for the many reasons mentioned above, what are some of the tax planning opportunities available to taxpayers to help ease in this transition?Extended Payment Adjustment Period: Under current tax rules, if a taxpayer charges its accounting period form LIFO to another acceptable method, and it results in a higher inventory value, the difference in additional tax is payable over a period of four years. Under the current Obama Administration's 2010 Budget Proposal, the difference would be spread to taxable income and payable over eight years. Consequently, the termination of LIFO would be mitigated as the resulting extra tax would be payable to the tax authorities over an eight year period.Net Operating Loss: Given the current recession, a company may have encountered losses in the last two years. Under current U.S tax rules, IRC 172 such losses can be used to offset in part or in full, past profits for the last 2 years and/or future profit for the next 20 years; known as the 2/20 rule.

CONCLUSION

The probability of the elimination of LIFO as an acceptable accounting method is very unlikely in the near future. This paper has addressed the present and future outlook of LIFO. In the authors' opinion, LIFO will continue as is in the indefinite future due to more critical pressing political and economic issues, and will not be addressed again until at the earliest until 2013-2014. Worldwide financial reporting will continue to have differences as there exists. The possibility convergence or a complete rejection of IFRS in the US exists. In the event of LIFO's eventual repeal, the authors recommend several tax strategies to help ease the burden of this change. Additional research examining the managerial, non-tax advantages of FIFO when compared to LIFO should be addressed.

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