

## **Throwing a Life Saver to LIFO: IFRS Adoption or Incorporation?**

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*Increased globalization of business has caused many in the financial community to question the continued use of generally accepted accounting principles (GAAP) for financial reporting. Initially, the push was to eliminate GAAP and adopt international financial reporting standards (IFRS). In the rush to adopt IFRS, the impact of this decision upon U. S. companies has not been thoroughly studied. The purpose of this paper is to discuss the impact the adoption of IFRS and subsequent elimination of last-in, first-out (LIFO) on U. S. business.*

### **INTRODUCTION**

The accounting profession is witnessing some of the most traumatic changes experienced since its inception. In 2002, the Sarbanes-Oxley Act changed the manner in which auditing had been performed for more than fifty years. Now, the foundation of the reporting function is being shaken by the elimination or radical modification of generally accepted accounting principles (GAAP). While the Enron and WorldCom audit scandals drove the enactment of Sarbanes-Oxley, the impetus to change GAAP is derived from an increased globalization of business finance.

Many in the financial community originally lauded the change of GAAP to International Financial Reporting Standards (IFRS). This change was encouraged by the AICPA and others to allow domestic corporations to trade on foreign markets and foreign corporations to trade on U.S. markets without the need to convert financial statements to comply with the accounting principles of another country. Initially, the proposal was to eliminate GAAP and adopt IFRS.

The first movement away from the adoption concept was known as convergence. The originators thought the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) could negotiate their differences into a set of principles acceptable to all by 2010. After a two year period of conferences, it is becoming apparent that the differences between GAAP and IFRS are greater than previously thought and may be irreconcilable.

Recently, the Securities and Exchange Commission (SEC) and FASB concluded that convergence was not working. The newest proposal, which the SEC commissioner calls incorporation, is to blend IFRS into GAAP as far as practical. This incorporation would allow sections of current IFRS that are thought not to be useful to be “carved out.”

In the rush to create a universal set of accounting standards, the impact of this decision upon U. S. companies has not been thoroughly studied. One area that has not been resolved in these conferences is

acceptable inventory cost flow assumptions. The purpose of this paper is to discuss the impact of the adoption of IFRS and subsequent elimination of the last-in, first-out (LIFO) inventory cost flow assumption on U. S. businesses.

## **HISTORY OF GAAP**

Generally accepted accounting principles evolved from long accepted practices used by the accounting profession. These principles were not codified until 1939. The stock market crash of 1929, the many bank failures, and the ensuing depression resulted in many people blaming accountants for their dilemma. Accountants had no formal basis for supporting their work when called to testify in court. The Securities Acts of 1933 and 1934 gave the Securities and Exchange Commission (SEC) control over accounting by publicly traded companies. Previts and Merino (1998) state that the SEC propelled the American Institute of Accountants (AIA) in 1939 into establishing the Committee on Accounting Procedures (CAP) which began to issue accounting research bulletins (ARBs). These accounting research bulletins were the beginnings of GAAP.

GAAP continued to evolve over the next thirty years. The CAP was replaced by the Accounting Principles Board (APB) in 1952, which issued Opinions that became part of GAAP. The APB sustained criticism for failing to develop a conceptual framework to act as a structure for development of accounting standards. This failure led to the formation of the Financial Accounting Standards Board (FASB) in 1973. Between 1973 and 2010, FASB conceived and implemented over 170 Statements of Financial Accounting Standards, further expanding GAAP content. In 2009, FASB formally codified all existing GAAP into one source, both simplifying and complicating GAAP knowledge. This process simplified GAAP by placing all content in one location which allowed easier access. This codification renumbered all the ARBs, Opinions, and SFASs which made it more difficult for accountants who knew GAAP by number to determine the location of a particular issue.

## **THE ARRIVAL OF IFRS**

A movement for the adoption of international accounting standards began in the 1980's with the formation of the International Accounting Board (IAB). This organization was formed with members from different countries in an attempt to reach a consensus for accounting standards. At first, little success was achieved as the board had no authority to enforce its actions. The movement gained strength in the 1990's and the name of the organization was changed to the International Accounting Standards Board (IASB). The standards originally proposed as international accounting standards (IAS's) were renamed international financial reporting standards (IFRS). Progress was made in 2002, when FASB and IASB pledged to make existing reporting standards fully compatible. This came to be known as the "Norwalk Agreement." Although the movement weakened for several years, it regained momentum under the auspices of Sir David Tweedie, former chairman of IASB and current president of the Institute of Chartered Accountants of Scotland.

## **CONVERGENCE ISSUES**

Accounting principles developed over time in different countries. In each of these countries, the prevailing culture of the country (political structure, tax structure, corporate structure, etc.) determined what accounting principles were appropriate. A number of contentious issues would need to be addressed if true convergence of GAAP and IFRS is desired. Jermakowicz and Epstein (2008) report that these issues include LIFO, liabilities versus equity, financial instruments, revenue recognition, expense recognition, measurement of non-financial assets, liabilities, ratio analysis, and industry specific guidance. While some issues have been resolved, several still need to be addressed. Among these issues are the effects of the elimination of LIFO.

There is a semantic problem with combining GAAP and IFRS as they are fundamentally different. Proponents of IFRS adoption have lauded IFRS as broad-based principles which require seasoned judgment to apply. GAAP is described as being rules-based. The convergence of rules and principles appears to be similar to combining apples and oranges.

Some have suggested that IFRS should just be adopted in its entirety due to the length of time necessary to arrive at convergence. This adoption would result in the elimination of FASB, since its purpose would be obsolete. In addition, the role of the SEC would be greatly diminished or eliminated as well. The elimination of these two bodies would place the setting of accounting standards under the auspices of an international body which might not be in the best interests of the United States. Cohn (2012b) states that “(T)he U.S. is not alone in wanting to maintain its autonomy in setting accounting standards.”

## **INCORPORATION**

While many European regulators have exhausted their patience with IFRS convergence issues, SEC chair Mary Schapiro will not be rushed into a decision on IFRS. Cohn (2012a) states that “...the SEC has recently given encouraging signs that it will ultimately allow IFRS to be incorporated into the U.S. financial reporting system...” Incorporation has been deemed by Miller and Bahnson (2012) to mean a “positive-sounding replacement for the inelegant term ‘carve-out’ in which a country uses IFRS only after removing offending portions.” They further suggest that the concept of incorporation was derived from a desire to placate “FASB and others who don’t like giving up U.S. sovereignty.” It also prevents debt covenants and legal statutes from having to be rewritten to replace GAAP with IFRS. Finally, incorporation would allow FASB to carve out the IFRS standard on inventory cost flow assumptions and replace it with current GAAP which allows LIFO.

## **HISTORY OF LIFO**

LIFO is a cost flow assumption used by approximately one-third of U.S. companies to determine cost of goods sold and the value of ending inventory. This cost flow method assumes that the last units purchased are the first units sold. This method results in a higher cost of goods sold than other methods during inflationary periods. A higher cost of goods sold results in a lower net income. Fewer taxes are paid when LIFO is used for determining taxable income. Since this is decidedly advantageous for tax accounting in periods of rising prices, the Internal Revenue Service (IRS) mandates using LIFO for financial reporting if LIFO is used for tax accounting. This is known as the LIFO conformity rule.

Daly (1953) reports that LIFO began as part of the Revenue Act of 1938. Initially, only a few industries were authorized to use LIFO. Even when the IRS authorized general use of this inventory method, few companies chose to use LIFO until a general inflationary period began during the Korean War. During this inflationary period, high corporate income tax rates were enacted to pay for the war debts. More companies chose to use LIFO to avoid paying these higher taxes.

The use of LIFO has both advantages and disadvantages. Daly (1953) reports that, over the complete price cycle, LIFO profits are more stable than first-in, first-out (FIFO) profits. As previously related, LIFO usage during inflationary periods produces lower taxes and a higher cash flow. Hence, LIFO has managerial implications.

Coffee, Roig, Lirely and Little (2009) state that LIFO provides an “enhanced measurement of periodic income” because of a “better matching of current sales prices with current costs.” Jennings (1996) reports LIFO produces a better measure of income and a higher quality of earnings. In addition, he found that LIFO income statements explain slightly more cross-sectional variation in equity values.

LIFO has two additional advantages. One advantage is it provides a lower value for inventory and reduces the associated property tax at the city/state level. Another advantage is LIFO allows companies to more easily maintain inventory levels. LIFO lowers taxable income and reduces income taxes paid.

Deferring inflationary gains on inventory sold allows companies to reinvest in more costly inventory. Without these tax savings, companies might not be able to maintain the same inventory levels.

LIFO has disadvantages as well. Coffee et al. report that LIFO causes distortions and comparability problems that result in a lack of transparency. FASB would like to eliminate methods such as LIFO which produce these distortions. In addition, LIFO does not work well for companies in which economies of scale cause new levels of products to cost less than older units. In this environment, the use of LIFO actually results in higher taxable income.

## **EFFECT OF LIFO ELIMINATION**

Mulford, Comiskey, and Thomason (2008) report that approximately 36 percent of U.S. companies use LIFO for at least part of their inventory. What will happen if LIFO is eliminated by IFRS adoption? First, due to the LIFO conformity rule, companies could no longer use LIFO for tax reporting. The repeal of LIFO would increase corporate taxes on U.S. businesses. Although the recession has ‘officially’ ended, the economic recovery is shaky at best. Increasing taxes might be the “straw that broke the camel’s back.”

Additionally, the elimination of LIFO would cause companies to recapture LIFO reserves and the deferred tax benefits caused by them. This elimination would cause an immediate tax liability of gigantic proportions. Depending upon how long a company has used LIFO, these reserves could be larger than a company’s net worth. This effect would cause companies to pay taxes on decisions made by company management many years ago. Many companies might not be able to finance this huge cash flow drain and would not survive.

A third effect of LIFO elimination would be increased state and local taxation (SALT) on corporations. Since state and local taxes piggyback off of federal tax law, SALT will definitely be higher for corporations. Hymers (2009) reports accounting professionals should know how IFRS will potentially impact SALT.

Finally, LIFO elimination has been determined to have qualitative effects as well. Paananen and Lin (2008) determine that adoption of IFRS has caused a decline in accounting quality in Europe since the mandatory EU adoption in 2005. They maintain this effect “makes it harder for investors to base their decisions on IFRS financial reporting.” If this effect is duplicated in the U.S., LIFO removal could cause more irrational decision making by the U.S. investor.

## **CONCLUSIONS**

The conditions of the Norwalk Agreement require fully compatible reporting standards for all parties bound by the agreement. This will be extremely difficult to fulfill. Several reasons exist for this observation. The first reason is that GAAP and IFRS are diametrically opposing sets of standards. One is rules-based and the other is principles-based. It is extremely difficult to blend the two styles together.

Another reason for the difficulty is that accounting standards were established due to the prevailing culture. Changing any culture is extremely difficult, painful, and time consuming. Attempting to accomplish this in a short time period will be difficult, if not impossible, to achieve. There may also be legal implications caused by this change.

Thirdly, eliminating some of the U.S. rules in GAAP, especially LIFO, could cause economic upheaval in a time of distress. Companies will have to recapture LIFO reserves and also pay additional taxes in the future. Many small to medium size companies may not have the cash reserves to comply with this draconian event.

Next, neither adoption nor convergence might be in the best interests of the United States. Both adoption and convergence would eliminate the need for FASB and possibly the SEC. If enacted, an international organization would determine U.S. reporting standards. In addition, IFRS does not provide the same degree of topical coverage as does GAAP. Thus, adoption alone would eliminate many areas of financial reporting that GAAP currently addresses.

Additionally, convergence is a time-consuming and counter-productive process. The expectation that two diverse bodies such as FASB and IASB could totally agree on every aspect of financial reporting was overly ambitious. Also, no self-regulating body would voluntarily relinquish its authority to another.

Finally, while both GAAP and IFRS have been improved by the convergence effort, incorporation seems to provide the only reasonable solution to financial reporting for the U.S. Under incorporation, both FASB and IASB would retain autonomy over their own standards. The best of IFRS would be incorporated into GAAP. FASB would retain the areas in GAAP not addressed by IFRS and would carve out those areas not adaptable to the U.S. business culture. Thus, incorporation is the lifesaver for LIFO.

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