NATIONAL CENTER FOR POLICY ANALYSIS

The Accounting War: Inflation, Taxes and Financial Transparency

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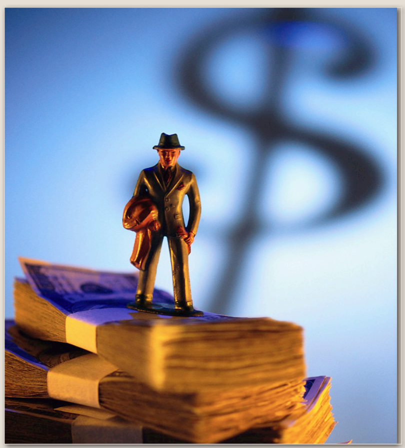
A seemingly technical accounting issue has important implications for competition between large corporations and smaller firms, for U.S. businesses overseas, and for the ability of individuals to understand the true financial condition of the firms in which they invest.

The GAAP between U.S. Accounting and International Standards. Since August 2008, the U.S. Securities and Exchange Commission (SEC) has promised greater congruence between Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). GAAP standards, used domestically in the United States, were established by the Financial Accounting Standards Board (FASB), a private organization dominated by major accounting firms. In 1973, the SEC designated FASB as the standards-setting organization for publicly traded businesses. IFRS policies, however, are set by the International Accounting Standards Board (IASB). Harmonizing the two standards would have global effects:

- Standardized financial statements across borders would greatly facilitate the merger and acquisition (M&A) activities of multinational corporations, or businesses that wish to become multinational.
- Multinational corporations would no longer need to implement the time and cost intensive process of "translating" international financial statements into GAAP-compliant documents.
- Shared standards would improve the ability of global investors to compare information across countries.

Inventory Valuation Affects Taxable Income. However, the most important and fiercely contested implications of adopting U.S. standards congruent with IFRS is the effect on businesses' bottom lines. And one of the most controversial issues in this debate is the elimination of the Last In First Out (LIFO) method of inventory valuation.

First In First Out (FIFO) requires companies to record their most recently sold goods with costs assumed earlier in the year; as a result, the timing of the good's sale has less effect on taxable income, since less time has passed for inflation to affect its value. Unlike FIFO, LIFO inventory valuation allows companies to stockpile relatively inexpensive inventory purchased over the course of many months, and use the sale of identical inputs they acquired more recently at a higher cost to artificially increase the cost of goods sold, thus minimizing taxable income. These goods are typically more expensive due to inflation, and a manipulative manager could use this discrepancy to his advantage. After periods of notable inflation, liquidating these "layers" of residual, less expensive inventory — known as LIFO liquidation — allows companies to vastly increase their *recorded* profits.



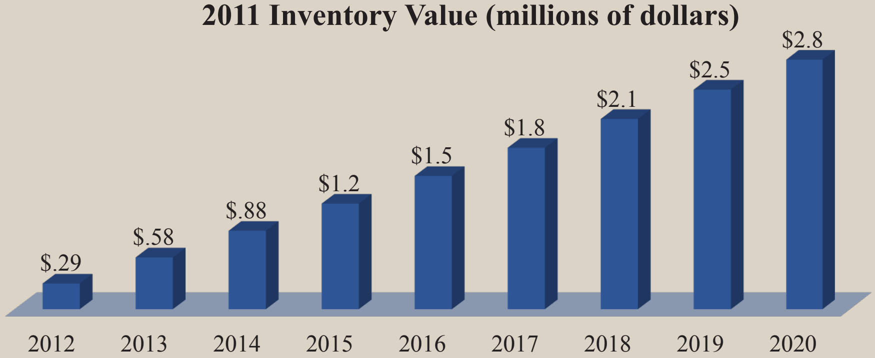
Dallas Headquarters:
14180 Dallas Parkway, Suite 350
Dallas, TX 75254
972.386.6272

www.ncpa.org

Washington Office:
600 Pennsylvania Ave., SE
Suite 310
Washington, DC 20003
202.830.0177

National Center for Policy Analysis

Figure I
Unrecorded Inflation Effects on General Motors' 2011 Inventory Value (millions of dollars)



Note: The projection does not reflect estimates by General Motors Company, but simply assumes inflation of 2 percent per year.

Source: "Consolidated Statements of Income," General Motors Company, 2013.

According to proponents of FIFO and IFRS, both LIFO liquidation and the minimization of taxable income paint an inaccurate picture of a company's true financial position. Furthermore, large companies that know how and when to artificially suppress profits and inventory can circumvent millions of dollars in taxes. This factor gives larger firms an undeniable competitive advantage against smaller entrants, reducing market competition. Thus, critics say LIFO is a tool for tax avoidance, investor manipulation and widespread confusion among investors unfamiliar with accounting.

For example, in fiscal year 2013, Honda Manufacturing Corporation, which uses FIFO, reported over $12 billion in inventory, and net income of $5.5 billion. By contrast, General Motors (GM), which uses LIFO, reported just over $14 billion in inventory, and net income of $5.3 billion. Individuals who seek to invest their money or make a business decision based these numbers may have a strong aptitude for interpreting financial statements, and they may employ methods to weigh, index or generate financial ratios based off of income and assets. Unfortunately, however, without the often time-and cost-intensive process of translating statements and financial data, a direct comparison would be a shot in the dark.

Figure I shows a conservative estimate of changes in inventory valuation over time — with an assumed 2 percent annual inflation rate, rather than the U.S. historical average of 3.33 percent. While changes in valuation may seem meager, it is important to remember that a company which accrues inventory over time rather than keep a constant account of inventory (another assumption in the figure) can greatly increase the rate at which it reduces taxable income and increases inventory assets. Additionally, only the cheapest purchased goods are accumulating in inventory, as the company attributes sales to more recent and expensive goods in order to reduce its taxable income. Thus, liquidating these inventory assets all at once, known as LIFO layer liquidation, could allow irresponsible managers who have purchased and stockpiled cheap goods to eventually sell them in bulk at a higher markup.

In all likelihood, GM overstated production costs compared to Honda, and its inventory was recorded as less expensive than it truly is, due to marginally outdated cost figures accrued over the period of inflation. General Motors also has an incentive to purchase and hoard inputs near the beginning of the year, which it can sell at the end of the year at a higher recorded cost in order to reduce taxable income. The concern is that the two companies can no longer be adequately compared due to the different methods of inventory valuation used. Thus, investors may be unknowingly exposed to more risk due to imperfect information.

A 2008 study by Charles W. Mulford and Eugene E. Comiskey of the Georgia Institute of Technology looked at the impact on companies if they were forced to switch to the FIFO method. The researchers found that, "on average, had FIFO been used by these firms in 2007, pretax income and net income would be higher by 11.97% and 7.42%, respectively, the current ratio would be higher by 26.2% and shareholders' equity would be higher by 34.2%. Of particular note is the significant amount of income taxes that these firms would owe, ranging up to the hundreds of millions if not billions of dollars, if they were required to adopt FIFO accounting."[1] [See Figure II.]

The study also found a disproportionately high tax burden on energy companies, where the disappearance of LIFO layers was projected to *decrease total assets by a range of 9 percent to 31 percent,* depending on the company.

The SEC, which became distracted by the Great Recession, stalled implementation of its 2008 drafts of a roadmap to GAAP and IFRS convergence. The hopes of investors, smaller manufacturing firms and companies with quick cash flow movements, such as retailers, were ignited again when the SEC's "2010 – 2015 Strategic Plan," promised global standardization in accordance with FIFO, investor protection and fair play in the marketplace.[2]

LIFO's elimination seemed closer than ever when the Obama Administration's proposed 2011 federal budget attempted to prohibit the use of LIFO, projecting revenues from recovered taxes of more than $59 billion over the course of 10 years. Specifically, the administration's plan would require companies to begin paying taxes on profits trapped in "LIFO Reserves," or unused LIFO liquidation layers. However, manufacturing companies opposed the move, and succeeded in stalling the plan. Businesses cited the more benign benefits provided by LIFO, testifying before Congress that many manufacturing organizations with slow inventory flows tend to underestimate profits in order to mitigate the cost of write-downs in the value of inventory. Since the value of ending inventory under LIFO is already generally very conservative, the decreasing value of the asset account has little effect on actual income.

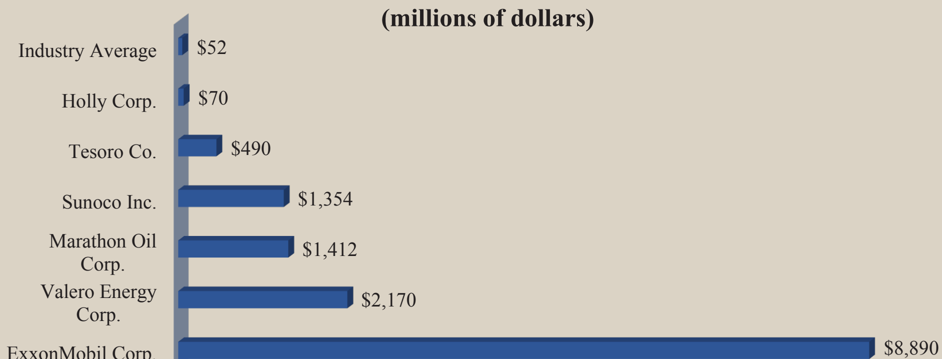
Especially vocal LIFO proponents such as O'Neal Industries, a metal manufacturer, have appealed to Congress, stating that "inflation built into the product is not recognized for tax or book purposes."[3] O'Neal Industries claimed the improvement in short-term reporting accuracy is not a competitive advantage but a financially conservative necessity, because although LIFO does match most recent expenses with most recent costs, it *only does so for goods purchased and sold in the same year*. A number of witnesses at hearings on these issues said Congress does not adequately understand the technical details behind LIFO. Congress quickly dropped the issue.

SEC Chairman Mary Jo White, President Obama's appointee, has not signaled any movement in the direction of IFRS; and, oddly enough, the SEC drafted a new "2014 – 2018 Strategic Plan," which actually suggests distancing GAAP from IFRS.[4] As stated in the new strategic plan, the SEC "will consider, among other things, whether a single set of high-quality global accounting standards is achievable," as opposed to its earlier promises to uphold "a single set of high-quality global accounting standards"[5] and "ongoing convergence initiatives between" IFRS and GAAP… which has clearly not materialized.[6]

Conclusion. Despite mounting international and domestic pressure for standardization, companies have two notable reasons to keep LIFO: minimizing taxable income and attracting equity by having more control over their financial statements. These advantages are consequential, considering the vast size of large firms' inventories. And the upper hand given by LIFO valuation may foster an environment that is not conducive to competition, especially in the case of smaller firms. With these concerns in mind, Last In First Out inventory valuation — a measure protected under principles of GAAP — will not go quietly. Accounting standards will remain a point of contention for years to come.

Santiago Bello is a research associate with the National Center for Policy Analysis.

Figure II
Cumulative Projected Tax Cost of Switching to FIFO for Selected Firms
(millions of dollars)



Source: Charles W. Mulford, Eugene E. Comiskey and Joshua Thomason, "The Potential Consequences of the Eliminiation of LIFO as a Part of IFRS Convergence," Georgia Tech Financial Analysis Lab, April 17, 2015.

Notes

[1] Charles W. Mulford, Eugene E. Comiskey and Joshua Thomason, *"The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence,"* Georgia Tech Financial Analysis Lab, December, 2008. Available at http://scheller.gatech.edu/centers-initiatives/financial-analysis-lab/files/2008/ga_tech_cf_lifo_2008.pdf.

[2] *"Strategic Plan For Fiscal Years 2010 – 2015,"* Securities Exchange Commission, October 8, 2009. Available at http://www.sec.gov/about/secstratplan1015.pdf.

[3] Marie Leone, *"Sucking the LIFO Out of Inventory,"* CFO, July 15, 2010. Available at http://ww2.cfo.com/accounting-tax/2010/07/sucking-the-lifo-out-of-inventory/.

[4] *"Strategic Plan Fiscal Years 2014-2018,"* Securities Exchange Commission, February 3, 2014. Available at https://www.sec.gov/about/sec-strategic-plan-2014-2018-draft.pdf.

[5] IAS Plus, *"SEC remains committed to convergence in general,"* Deloitte, February 5, 2014. Available at http://www.iasplus.com/en/news/2014/02/sec-draft-strategic-plan.

[6] *"IFRS in the US: The importance of being financially bilingual,"* PricewaterhouseCoopers, February 2014. Available at http://www.pwc.com/en_US/us/issues/ifrs-reporting/publications/assets/pwc-ifrs-in-the-us-the-importance-of-being-financially-bilingual.pdf.