The Effects Of LIFO (Last In, First Out) Repeal On The Entertainment Industry

Peter Harris, New York Institute of Technology, USA

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 SEC in conjunction with the International Financial Accounting Standards Board (IFRS) to standardize accounting practices worldwide. In addition, there is political pressure imposed by the US Obama administration to raise additional revenues. Both groups strongly oppose LIFO, raising a strong possibility that its complete elimination as an accounting method will occur by as early as 2014. This paper addresses the effects of LIFO repeal on the entertainment industry. The result will probably be the elimination of the Lower of Cost or Market Method, which is presently adapted by many non-LIFO firms, and also represents a major tax loophole for those who use it, including the entertainment industry.

Keywords: LIFO; Last In, First Out; Lower of Cost or Market Inventory Valuation; IFRS; LIFO Reserve

INTRODUCTION

The Last in, First Out (LIFO) method has been an acceptable, popular accounting method since its inception in 1939. Since then, many argue - and continue to - against LIFO as a viable, economic, realistic accounting method. At present, LIFO faces a strong and real possibility of its elimination by the year 2014, as political forces coming from the International Financial Accounting Standards Board and the Obama administration strongly oppose this method. The International Financial Reporting Standards (IFRS) prohibit LIFO as an acceptable accounting method and the Obama administration has proposed, in its 2010 budget, to repeal LIFO altogether in the future.

Acceptable Accounting Methods Under US GAAP And US Taxation

Presently, there are three acceptable inventory methods under US Generally Accepted Accounting Principles (GAAP) and the US Internal Revenue Code (IRC), which include; The Last in, First Out (LIFO), First in, First Out (FIFO), and the Weighted Average methods. Under international Financial Reporting Standards (IFRS), LIFO is not a permissible method. LIFO assumes that the last or most recent purchases of inventory are sold first. FIFO assumes that the first inventory purchases are sold first and the Weighted Average Method weights the entire inventory on the basis as one unit cost in its inventory valuation base. LIFO has an inherent tax advantage in inflationary periods as the higher cost inventory items are expensed against revenue, resulting in lower income and lower tax payments. This advantage has been criticized by many as an unfair tax loophole and the principal reason one uses LIFO is to gain this tax benefit. The literature is in agreement with this assessment.

Plesko (2006) has labeled LIFO as a "tax holiday" for the few. White, Sondhi and White (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.

Shackelford and Sheulin (2001) have documented the tax motivated effect of LIFO. Dopuch and Pincur (1988) found that the taxation effect was the primary reason a company chose LIFO.

المنارة للاستشارات
www.manaraa.com

The tax advantages of LIFO are thus dependent on inventory additions or build-ups, known as reserves at increasing prices, or inflationary trends.

The following example will illustrate this point in an inflationary environment scenario where the company will have a greater cash flow of $4.80 in the form of lower tax payments, simply by adapting LIFO.

In its first year of operation, suppose that Company X purchases inventory as follows (rising prices or inflationary trend):

	Units	Cost/unit		Total cost
January 15	100 units	@$10.00	=	$1,000
March 15	100 units	@$10.20	=	$1,020
June 15	100 units	@$10.40	=	$1,040
December 15	100 units	@$10.60	=	$1,060
Total	400 units			$4,120

At year end, an inventory count reveals 20 units in its ending inventory.

The following costs of goods sold would result under the following three methods of accounting (FIFO, LIFO and weighted average):

	FIFO	LIFO	Weighted Average
Beginning inventory	0	0	0
+ Purchases	$4,120	$4,120	$4,120
Total available for sale	4,120	4,120	4,120
Less Ending Inventory	[1] (212)	[2] (200)	[3] (206)
Cost of Goods Sold	$3,908	$3,920	$3,914

1. FIFO: The ending inventory is represented by the last purchases made at $10.60 each (20 x $10.60 = $212).
2. LIFO: The ending inventory is represented by the first purchases made at $10 each (20 x $10.00 = $200).
3. Weighted Average: The ending inventory is represented by the weighted average cost - Total cost/total units = $4120/400 = $10.30 per unit.

RESULTS

LIFO will result in a $12 higher cost than FIFO by virtue of inflation. This will result in a lower pretax income of $12 and a tax savings of $12 times the tax rate. Assuming a 40% tax bracket, LIFO will result in a lower tax payment of 40% x 12 or $4.80 and a lower net income of $12-$4.80 or $7.20. FIFO will result in a higher pretax income of $12, a higher tax payment of $4.80 and a higher new income of $7.20. (The weighted average method results will be between the LIFO and FIFO method).

The Lower Of Cost Or Market Method (LCM) Of Inventory Valuation

Non-LIFO users have a tax loophole known as the Lower of Cost or Market (LCM) method to account for inventory. LCM is coupled with the FIFO or Weighted Average Inventory method. Under the Internal Revenue Code**,** if a non-LIFO method is used, the tax rules allow use of the LCM rule to value inventories. LCM allows inventory to be valued below cost if it 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 take a tax advantage prior to sale by the use of non-LIFO LCM method. This method is not a viable option for LIFO users as these companies historically experience increasing, rather than deflationary, inventory costs.

المنارة للاستشارات
www.manaraa.com

As discussed before, the tax advantage of LIFO assumes increasing prices of inventory as well as an inventory build-up, known as reserves. In the entertainment industry, such as restaurant and food specializations, inventory build-up is not a feasible option as spoilage costs will greatly outweigh any tax benefit derived from LIFO. As an example, if we assume 3-4 percent inflation rate in food prices, the tax benefit to be derived, absent any costs, is the tax rate times the inflation rate times the inventory build-up/reserves. Assuming a 30 percent tax rate and a 3.5 inflationary rate, the tax benefit derived by the entertainment industry is 1.05 percent times the inventory reserve. As food is a perishable item, the loss of carrying inventory will be much greater than 1.05 percent and the result is that there will not be an inventory build-up nor a tax benefit associated with LIFO use in the entertainment industry. A more effective and viable managerial decision is for the entertainment company to elect FIFO coupled with the Lower Cost or Market Method (LCM). In this case, one would sacrifice the 1.05 percent advantage of LIFO but gain the loss of inventory value as an inventory expense in the current period, resulting in a reduction in taxable income. As long as the obsolescence cost of the ending inventory is more than the inflation rate of inventory, there will be a tax benefit by the use of LCM. Following is an example to illustrate this point:

Assume Restaurant ABC sells a variety of food and has experienced a historical increase in purchase costs of 4 percent and an obsolescence rate of 10 percent for unsold inventory. It does not increase its inventory amounts year in and year out. Its beginning inventory is $100 and its ending inventory is $104, by virtue of inflation, and they have elected the FIFO method of inventory coupled with LCM. The tax benefit is calculated as follows: Ending Inventory of $110 multiplied by 90 percent replacement value of ending inventory, which equals $99. There is a write-down of inventory of $11, or 10 percent of ending inventory ($110). This write-down to market value represents a loss which is currently deductible for tax purposes, yielding a lower tax liability equal to the tax rate - in this case, 25 percent times the market loss of $11, or $2.75. In this same scenario, if one assumes an increase in inventory due to price inflation, use of LIFO will result in a tax benefit of the increase in tax reserve multiplied by the tax rate. In this case, the result will be a $10 increase in LIFO reserve times the 25 percent tax rate which equals $2.50.This is similar to the LCM tax benefit and, as such, also represents a "tax loophole" in the tax code.

Consequently, an inventory tax loophole exists for increasing inventory pricing goods, such as commodities, as well as perishable and deflationary inventory goods, such as food, computers, and computer chips. The negative reaction to LIFO is perhaps due to the fact that LIFO users represent the firms that do well financially and therefore catch the public's eye. ExxonMobil, for example, is the highest profitable company in the world and, of course, uses LIFO.

The Current And Future Outlook Of LIFO

LIFO is facing pressures from both the International Reporting Standards Board, in cooperation with the SEC, and the US 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 (US GAAP) when filing on US Stock exchanges. Foreign public firms are now permitted to file using the International Financial Reporting Standards (IFRS) without reconciliation to US GAAP as previously required. This move has created a mandate to converge IFRS and US 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. 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.

المنارة للاستشارات
www.manaraa.com

The four possibilities of LIFO going forward are 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 it is. Given extreme dual resistance from IFRS and Congress, this result seems most unlikely. The fact that LIFO users continue to decrease is a good indication that most believe that its repeal is eminent. At the beginning of 2000, approximately ten percent of publically traded US companies used LIFO, which is presently less than five percent. Furthermore, resistance to the abolishment of LIFO will greatly and potentially hinder the goal of uniform financial reporting going forward.

In Case 2, allowing LIFO for tax purposes - not for financial reporting purchases - represents the best of both worlds, as a company reports the highest income for financial reporting purposes and pays 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.

Case 3 represents the worst case scenario for a company; that is, it results in the lowest income reporting for financial statement purposes and the highest payment for tax purposes. This scenario is also not feasible.

Case 4 represents the complete elimination of LIFO. The author believes that this will occur. If LIFO is eliminated at the tax level, then it will be eliminated for financial reporting purposes as the advantage for business purposes would not exist. Given the huge US budget deficit, the tax loophole aspect of LIFO use and the movement to a uniform worldwide accounting reporting system make LIFO's future use as an acceptable accounting method very unlikely.

Given the ongoing and increasing international opposition to LIFO, coupled with the current spiraling of the US federal deficit, its support base is very unstable. The future of LIFO is then questionable and unlikely, with a repeal date effective December 31, 2014, representing the likely end of LIFO.

LIFO's Repeal And The Effects On The Entertainment Industry

Congressman Charles Rangel (2007) has called for the repeal of all of the tax loopholes, citing LIFO as a material culprit in this area. The US government estimates a loss of over $100 billion of tax revenue over the next ten years if LIFO is not repealed. The repeal of LIFO will undoubtedly lead to the repeal of The Lower of Cost or Market Tax loophole and will put the firms that use this method in a financial burden. The tax benefit realized by the entertainment industry will probably be repealed in the near future.

IFRS, if adapted, allows for The Lower of Cost or Market Rule to value inventory but defines market value as Net Realizable Value which equals sales price less the cost of selling the product. This amount is clearly much greater than replacement value, which is the current matrix used by the IRS to represent market value. In the event that the new tax laws adapt LCM to correspond to the IFRS rules, non-LIFO firms will have their tax losses decreased. This is due to the fact that IFRS uses the "higher" net realizable value to measure market value rather than replacement cost. The author believes there will be a total repeal of LCM in the event that LIFO is repealed.

The implications of the repeal of the LCM rule will force entertainment companies to manage their inventory better. Ideally, carrying no inventory is the best policy as the cost of inventory reserves exceeds any tax benefit. However, one needs to estimate potential stock-out losses in the event of not carrying enough inventories. As an example, a Just in Time (JIT) model may be adapted in an effort to minimize inventory losses. Better forecasting of sales, as a result of better quantitative modeling methodology, may be employed to help the entertainment industry.

المنارة للاستشارات
www.manaraa.com

CONCLUSION

The use of LIFO and The Lower of Cost or Market methods represent two tax loophole opportunities for US companies. With the upcoming convergence of IFRS, which disallows LIFO altogether, coupled with an out-of-control US tax deficit, both of these inventory tax opportunities are expected to be repealed by the period ending December 31, 2014. Such repeal will ultimately have negative effects on the entertainment industry as well as the industries that sell inventory. Companies will be forced to better manage their inventories as a result of such repeal. The limitations of this paper are the likelihood of the non-repeal of LIFO or The Lower of Cost or Market Methods. Additional research should be done on the cost of inventory stock-outs in the entertainment industry.

AUTHOR INFORMATION

Peter Harris is a Professor and Chair of the Accounting and Finance Department at the New York Institute of Technology. His research interests are International Accounting, Inventory Valuation Methods and Foreign Currency Risks. He has written a number of refereed journal articles on these topics. He worked for Ernst and Young, LLP prior to teaching and is a member of several professional organizations. E-mail: pharris@nyit.edu

REFERENCES

1. Cushing, B., and LeClere, M., Evidence on the Determinants of inventory Policy, *The Accounting Review*, April, 1992.
2. Compustat.
3. P. Harris, S. Shapiro, The Financial Implications of LIFO Repeal, Financial Management Association, October ,2010, New York City, NY, USA.
4. International Financial Accounting Standards (IFRS).
5. Internal Revenue Code (I.R.C.) 172, Net Operating Loss.
6. Internal Revenue Code (I.R.C.) 471 and Treasury Regulations 1.1471, Taxation of Inventory.
7. Internal Revenue Code (I.R.C.) 472, Taxation of the LIFO Inventory Method.
8. Internai Revenue Code (I.R.C.) 481, Payment of tax due to changes in accounting methods.
9. Kieso, Weygandt, and Warfield, Intermediate Accounting, 11th Edition, Wiley, 2005.
10. PWCoopers.org.
11. Comments made by Congressman Rangel in his opposition of LIFO, 2007.
12. Romeo, Joseph, Analysis of LIFO Inventory Valuation Method during the Onset of IFRS, Digital Commons @U Conn., 2009.
13. Revise, Collins, Johnson, *Financial Reporting and Analysis*, 3rd Ed. Pearson, Prentice, Hall, 2004.
14. *The Analysis and Uses of Financial Statements*, White, Sondhi, Fried, Wiley, 3rd Edition, 2008.
15. US Generally Accepted Accounting Principles (US GAAP).

www.manaraa.com

NOTES

المنارة للاستشارات
www.manaraa.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

للاستشارات المنارة

www.manaraa.com