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governance | risk | compliance

Volume 2, Issue 2

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Black Swan Events

Lessons from the BP Oil Spill

GAAP to IFRS

Why LIFO Should be Retained

Policy Management

Defining and Enforcing Good Governance

Spring 2010
Volume 2, Issue 2

insidegrc

governance | risk | compliance

GAAP to IFRS
page 18

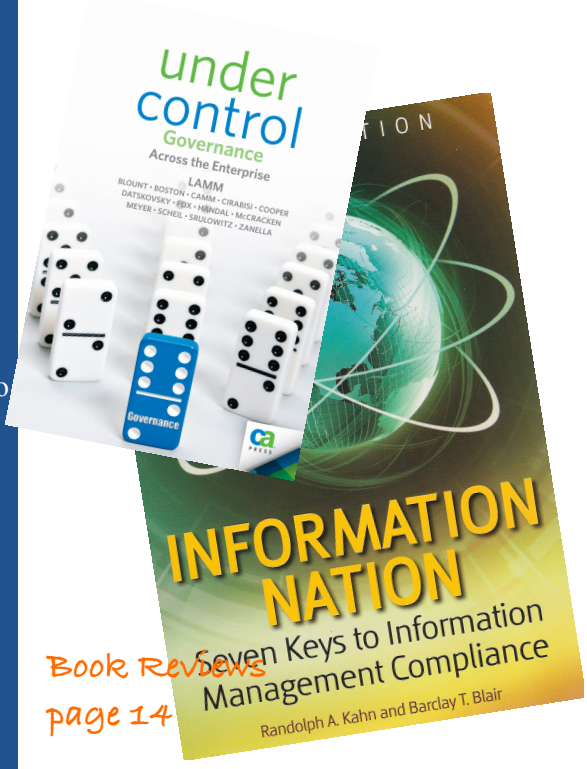
Information Security
page 9

In This Issue

Risk Management Lessons
from BP
page 5

Managing SoD
page 15

Policy Management
page 10



Book Reviews
page 14

GRC MVPs
page 2

IFRS

Why Good Corporate Governance Demands Taking an Active Stance Against the Elimination of LIFO for Tax Purposes

By Elaine Vullmahn, CPA, CIA and
Barry Jay Epstein, Ph.D., CPA

Most public companies in the U.S. are welcoming – or at least accepting – the prospect of transitioning from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to International Financial Reporting Standards (IFRS) in the near future. Well over 100 countries now require or permit the use of IFRS, and several others are committed to implementing IFRS in the near future. This global movement towards a single set of high quality financial reporting standards will lead to greater comprehensibility and transparency in financial reports and a consequent increase in cross-border capital flows. However, these advantages may come at a great cost to U.S. businesses if corporations do not take an immediate active stance against the elimination of the Last-In-First-Out (LIFO) inventory costing method, which is widely used for tax purposes.

The LIFO Inventory Costing Method

For over 70 years, U.S. taxpayers have been able to value the cost of their inventories using the LIFO inventory method. It is assumed, when calculating the cost of inventory under LIFO, that the last product to be added to inventory was the first unit to be sold. Although not a meaningful representation of the actual flow of goods, this does make great sense from both accounting and economic perspectives. By matching current economic costs against current revenues, LIFO costing produces a more meaningful measure of the actual performance of an entity, especially in an inflationary environment. Since this results in reduced levels of taxable income, LIFO lowers the outflow for current income taxes, conserving cash that can be deployed instead for profitable investments, expenditures, retirement of debt, and so on.

Today, approximately 35% of U.S. companies use LIFO inventory costing for at least some of their inventories. Companies primarily elect to use LIFO because of significant tax advantages: a company utilizing LIFO defers the payment of taxes, potentially indefinitely.

The LIFO Conformity Rule

Unique to the U.S. is the LIFO Conformity Rule. During the 1930s, Congress revised the Internal Revenue Code, which now includes Reg § 1.472-2, *Requirements incident to adoption and use of LIFO inventory method*. This Code section allows the use of LIFO for tax purposes, but requires that if LIFO is used to determine taxable income it must also be used for financial reporting purposes.

Under U.S. law, if a company ceases use of LIFO and adopts the First-In-First-Out (FIFO) or weighted average costing methods permitted under IFRS, it has to "absorb" the so-called LIFO reserve into the entity's taxable income over a four-year period. Today, it is estimated that LIFO "reserves" on U.S. corporate balance sheets total $90 billion. At an effective tax rate of 35%, over $30 billion of additional taxes will be owed, payable in cash over four years under current law, if LIFO is discontinued for any reason.

Inventory Costing Under IFRS

At one time, LIFO was an acceptable inventory accounting method under IFRS. However, several years ago the IASB eliminated LIFO because it made little sense from an accounting theory perspective. When this decision was made, the IASB gave little or no consideration to the tax implications, particularly since IFRS had not yet become accepted in the U.S., where the LIFO conformity rule exists.

In addition to the benefits, U.S. companies must consider how onerous and potentially devastating adopting IFRS may be. If they are required to report under IFRS, and IFRS does not allow LIFO, then companies will have to adopt FIFO or average costing. The pain will come from the fact that over a four-year period these entities will be required to pay the U.S. government as much as $30 billion dollars in additional taxes.

Elimination of LIFO for Tax Purposes

A cash infusion of as much as $30 billion would surely be welcomed by the government, and over the years there have been many thus-far unsuccessful attempts by Congress to eliminate LIFO for that reason. With IFRS adoption looming as an convenient excuse for a

"Directors and officers should begin to demand that Congress revise the tax code to allow companies to utilize LIFO for tax purposes even if they are required to utilize other inventory costing methods for financial reporting purposes, thereby preserving the companies' LIFO reserves and averting a cataclysmic outflow of cash."

ban on LIFO costing, one taxpayer concern has been addressed by President Obama, who has mentioned extending the four-year spread to possibly as long as ten years. Whether over four or ten years, however, conversion from U.S. GAAP to IFRS will have significant negative cash flow ramifications for many companies if the conformity rule remains in place.

Congress has long-characterized LIFO as being merely a tax dodge. Companies should not be lulled by the fact that all previous efforts at repeal have failed; cash-hungry federal and local governments, under the guise of trying to converge with IFRS, are more likely to succeed this time.

Governance Implications

Given the current liquidity crunch and heightened expectations regarding corporate governance, corporations should vigorously lobby against elimination of LIFO for tax purposes. To generate the approximately $30 billion needed to repay these tax deferrals in the current environment will be very challenging – and, even if possible, would reduce shareholder wealth by that sum. Boards' and managements' fiduciary obligations are consistent with efforts to retain the tax deferral advantages of LIFO, even if financial reporting under IFRS does not allow this accounting. Elimination of the LIFO conformity rule should therefore be a top agenda item for corporate lobbyists as well as individual company boards.

Modified IFRS as an Alternative Solution

The alternative strategy to preserve LIFO benefits is to urge adoption of a modified version of IFRS – i.e., one that would permit LIFO costing. However, this would obviate the goal of achieving uniform worldwide financial reporting and limit the myriad benefits that are expected to accrue from that uniformity. The EU's experience with "carve-outs" for financial instruments accounting under IFRS serves as an object lesson on the implications of permitting deviations from ostensibly universal accounting standards.

Thus, if the U.S. adopts IFRS, local variations should be rejected. Directors and officers should instead begin now to demand that Congress revise the tax code to allow companies to utilize LIFO for tax purposes even if they are required to utilize other inventory costing methods for financial reporting purposes, thereby preserving the companies' LIFO reserves and averting a cataclysmic outflow of cash. The economy of the nation will be better served by preserving this source of cash for capital investment than it would be by having a one-time tax windfall put into the hands of our profligate government.♦

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