Lesson Two: IFRS Inventory Case Study

One of the significant differences between IFRS and GAAP is the treatment of inventory. Specifically, the LIFO method of inventory costing used under GAAP is not allowed under IFRS.

Part I: Readings

Below are excerpts from a recent article in the Journal of Accountancy that highlights the possible effects of eliminating LIFO under GAAP:

The Death of LIFO?¹

Few differences between IFRS and U.S. GAAP loom larger than accounting for inventories, particularly the disallowance of the last-in, first-out (LIFO) method in IFRS. The proposed shift of U.S. public companies to IFRS could affect many companies currently using LIFO for both financial reporting and taxation. This is because the conformity rule of IRC § 472(c) requires taxpayers who apply LIFO for tax purposes to also apply it for income measurement in financial reporting, and IFRS does not permit LIFO for book accounting.

Therefore, CPA’s may be called upon to help manage inventory method changes. Companies using LIFO would have to switch to FIFO or average cost. The change would place companies in violation of the conformity requirement. Absent relief from the Treasury Department, it would require them to change their tax method of inventory reporting.

This article highlights the impact of LIFO accounting, widely used in the U.S. but scarcely used elsewhere. It could be eliminated if U.S. GAAP were to fully conform to IFRS inventory accounting. If LIFO were to disappear, many U.S. companies could face large income tax liabilities from accelerated income recognition.

In 2007, Exxon Mobil Corp. reported its aggregate replacement cost of inventories at year-end exceeded the inventories' LIFO carrying value by $25.4 billion. The SherwinWilliams Co. reported that if it had used FIFO instead of LIFO, its net income for 2005 would have been $40.8 million higher (Exxon Mobil Corp., 2007 SEC Form 10-K; , 2007 SEC Form 10-K).

The proposed SEC road map released in November contemplates some large U.S. companies voluntarily adopting IFRS, starting with filings in 2010. Its application could be mandated for large public companies starting in 2014.

Over time, LIFO can have a significant cumulative downward effect on the inventory's value. The cost of goods sold for any particular year equals the sum of beginning inventory, plus purchases, less ending inventory. Thus, a lower ending inventory increases cost of goods sold and reduces taxable income.

Companies adopt LIFO primarily to lower their income tax liability and to postpone paying taxes, but it also reduces income for financial reporting purposes. Nevertheless, companies are not required to use the same LIFO method for taxation and accounting. For example, a unit LIFO method could be used in accounting and a dollar-value LIFO method in taxation.

A change from LIFO will normally have a significant positive income effect because the accumulation of prior years' costs in beginning inventory will replace cost of goods sold valued at current costs. Assuming that the inventory turns over, income for the year of change would increase by the entire amount of the LIFO reserve.

Companies may well be reluctant to move to IFRS for inventory reporting if they are using LIFO, unless the LIFO conformity rule were relaxed. Perhaps they would be allowed to still report LIFO for tax but to adhere to IFRS for accounting. Maybe two sets of financial statements, one on IFRS, the other on GAAP permitting LIFO, would be allowed. Another possibility would be for the Treasury Department to extend the period over which those tax obligations are due beyond the currently allowed four years. Still another possibility would be for companies to offset the obligations against net operating losses with carrybacks and carryforwards. Or perhaps different reporting standards could be used for larger versus smaller companies. In any case, it is premature to say that LIFO is on its deathbed. Indeed, small companies not required to use IFRS may very well stay on LIFO.

For tax planning purposes, companies may consider reducing their inventories and their LIFO reserves gradually between now and changeover dates to IFRS. Some companies may decide to be early IFRS adopters, particularly if a net operating loss or other tax situation could minimize the impact of recapturing the LIFO reserve. Or they could wait and see what happens, anticipating some exception to the conformity principle or an extended section 481(a) period.
Part II: Problem and Questions

Please answer the questions below, using your knowledge of inventory costing methods obtained through class lectures and homework and information provided in the previous article.

Selbe Inc. is a retailer operating in Edmonton, Alberta. Selbe uses the perpetual inventory method. All sales returns from customers result in the goods being returned to inventory. (Assume that the inventory is not damaged.) Assume that there are no credit transactions; all amounts are settled in cash. You are provided with the following information for Selbe Inc. for the month of January 2010.

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Quantity</th>
<th>Unit Cost or Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Ending inventory</td>
<td>160</td>
<td>$20</td>
</tr>
<tr>
<td>Jan. 2</td>
<td>Purchase</td>
<td>100</td>
<td>22</td>
</tr>
<tr>
<td>Jan. 6</td>
<td>Sale</td>
<td>180</td>
<td>40</td>
</tr>
<tr>
<td>Jan. 9</td>
<td>Sale return</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>Jan. 9</td>
<td>Purchase</td>
<td>75</td>
<td>24</td>
</tr>
<tr>
<td>Jan. 10</td>
<td>Purchase return</td>
<td>15</td>
<td>24</td>
</tr>
<tr>
<td>Jan. 10</td>
<td>Sale</td>
<td>50</td>
<td>45</td>
</tr>
<tr>
<td>Jan. 23</td>
<td>Purchase</td>
<td>100</td>
<td>26</td>
</tr>
<tr>
<td>Jan. 30</td>
<td>Sale</td>
<td>120</td>
<td>50</td>
</tr>
</tbody>
</table>

a. Calculate cost of goods sold and ending inventory using LIFO under GAAP.

b. Calculate cost of goods sold and ending inventory using FIFO under IFRS.

c. Compare and contrast the income statement and balance sheet effects of part a and b. Will Selbe Inc. show a higher net income under GAAP or IFRS? Which set of standards will show a higher inventory value?

d. Based on your answer in part c., what possible reason do you think there is for not allowing LIFO under IFRS? What possible reasons do you there is for allowing LIFO under GAAP?

e. Recalling from the previous discussion in Lesson One the reasons for a push towards one set of accounting standards (increasing cross-border capital flows), do you think that allowing only one inventory method will be beneficial?

f. In the article, the authors note the difference between the replacement cost and the LIFO value of Exxon Mobil’s inventory. What does this disparity say about the value of the inventory reported on Exxon's balance sheet? Which value is more relevant? Which is more reliable?

g. What potential issues can you foresee with applying a global standard for inventory across different countries? Can you predict any potential inconsistencies?

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2 This problem is taken from Financial Accounting: Tools for Business Decision Making, 5th edition, Chapter 6, Problem 6-8A and adapted for this case study.