THE HISTORY OF LIFO—PART I

LIFO is an American invention, but the conceptual parent of LIFO, the base stock method, arose in the United Kingdom sometime in the late 1800s. The idea behind the base stock method is that a company must maintain a certain minimum quantity (base stock) of inventory in order to stay in business. This base stock will never be liquidated as long as the business is a going concern. Accordingly, the inventory base stock is similar in nature to a fixed asset and should be valued at the acquisition cost of the initial stock of inventory. Implementation of the base stock method requires management to designate how much of its inventory is base stock and what historical cost amount should be used to value the base stock.

In 1930, the U.S. Supreme Court ruled that the base stock method was not acceptable for tax purposes. (Those must have been exhilarating times for accountants—to have the merits of accounting methods debated before the Supreme Court!) The Supreme Court understood that the primary reason for a company to use the base stock method was not to more fairly reflect performance but to reduce income tax payments. LIFO was developed as an alternative to the base stock method that was not so dependent on arbitrary management designations of base stock quantities and prices. LIFO is beautiful in its definitional simplicity—the last goods in are the first goods out. And in practice, LIFO comes close to lowering taxes to the same extent as the base stock method.

Congress approved the use of LIFO for tax purposes in the Revenue Act of 1939, but it added an interesting stipulation known as the LIFO conformity rule: If you use LIFO for income tax purposes, you must also use it for financial reporting. In no other accounting area is there a legally mandated correspondence between tax accounting and financial accounting. What was Congress’ reasoning behind this LIFO conformity rule? Well, it is dangerous to try to fathom the intent of Congress. However, there is some belief that this condition was imposed in order to coerce auditors into being watchdogs for the IRS. The reasoning is as follows: In order to use LIFO for tax purposes, a company must also use it for financial reporting. The independent auditor must approve the financial statements and would not approve the use of LIFO if it didn’t fairly reflect the performance of the company. Presumably, if a company wants to adopt LIFO strictly for the purpose of reducing income tax payments, the auditor would not approve. Hence, the auditor becomes the watchdog for the IRS.

Like many Congressional schemes, this grand design has not worked out. Although the LIFO conformity rule is still in place, since 1953 financial accounting standards have not included any meaningful constraints on a firm’s choice among FIFO, LIFO, and average cost.

QUESTIONS:
1. If ending inventory levels are constant from one year to the next, is LIFO equivalent to the base stock method? How about if ending inventory levels are consistently growing from one year to the next?
2. If you were an accounting standard setter, what reasons would you give for banning LIFO? What if you were a government tax official?
3. Should Congress repeal the LIFO conformity rule?

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