Acceptability of "simplified LIFO" for financial reporting purposes; Issues paper (1982 October 14)

American Institute of Certified Public Accountants. Task Force on LIFO Inventory Problems

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The Acceptability of "Simplified LIFO" for Financial Reporting Purposes

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Background

Introduction

1. The Internal Revenue Service (IRS) recently issued regulations to simplify the use of the last-in, first-out (LIFO) inventory method for tax purposes by permitting companies to use a government price (external) index in determining the carrying amounts of inventories under the dollar value LIFO method. This has become commonly known as "simplified LIFO," which some believe is a misnomer because of the complexity of the approach. Appendix A to this paper presents a copy of the relevant IRS regulations.

2. Until now, many companies, particularly small companies, have found it overly burdensome, if not impossible, to compute their own LIFO index and they were prohibited (except for department stores) from using external indexes; therefore, they were, in effect, prohibited from using the LIFO method for tax purposes.

3. The IRS now accepts for tax purposes use of an external index, based on information determined by the U.S. Bureau of Labor Statistics (BLS), as an alternative to use of an inventory price index based on a company's experience. Appendix B to this paper discusses how the external indexes are derived and some of their other uses.

Description of Simplified LIFO

4. Simplified LIFO was designed by the IRS principally to allow small companies to use the LIFO inventory method without causing them to incur the costs of either determining an internal index or maintaining a detailed set of inventory records to support a unit based approach. The IRS regulations generally allow taxpayers to use only 80% of the change in government price indexes in developing their index. Certain small businesses, however, are permitted to use 100% of the change in the government price indexes.[1] The companies that qualify for simplified LIFO must use either the consumer price index (CPI) or producer price index (PPI), based on criteria established by IRS.

5. In an attempt to make the LIFO result more representative of a company's mix, the company must use the most detailed index categories in the CPI or PPI that comprise 10% or more of the carrying amount of the ending inventory. The BLS weights are then used to weight the index for each index item in the inventory. Once the category indexes are determined, they are weighted by the proportion of total ending inventory that comprise the inventory items in that category.

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1 A qualifying small business is defined as one with average annual sales for the prior three years of less than $2 million.

6. The simplified LIFO approach permits jobbers, distributors, wholesalers, and retailers to use 11 or fewer pools based on the CPI general categories plus a miscellaneous pool, if necessary. Manufacturers and processors must apply the IRS's usual pooling guidelines. The company must select a "representative" month for indexing, presumably the month in which inventory levels and mix would represent a "normal" inventory position. However, a company using the LIFO retail method must use the last month of its tax year. Both the CPI and PPI are reported monthly. The selection of the representative month for index determination is a one-time binding selection.

Basic Issue

7. The basic issue is whether simplified LIFO as discussed above should be considered acceptable for financial reporting purposes (a) when 100% of the external index is used and (b) when 80% of the external index is used.

Arguments

Acceptability of Simplified LIFO Using 100% of the External Index

8. For. Some believe simplified LIFO using 100% of the external index should be considered acceptable for financial reporting purposes, because nothing in the authoritative accounting literature prohibits use of external indexes in determining

the carrying amounts of LIFO inventories for financial reporting purposes. Further, current practice accepts the use of external indexes in applying the LIFO method to certain retailers. Also, some believe most of the accounting practices for LIFO inventories that have become generally accepted for financial reporting purposes have been based on the tax requirements for LIFO inventories. Those who support use of 100% of the external index point out that BLS indexes are scientifically determined and the detailed adjustments required to reweight the index to reflect a company's inventory mix normally should produce an index reasonably representative of a company's experience. Further, some believe that since inventory accounting methods are based on subjectivity and approximations anyway, an external index is as reasonable as an internal index.

9. Some also believe simplified LIFO using 100% of the external index should be considered acceptable for financial reporting purposes on practical grounds. They believe that if simplified LIFO will save many companies considerable time and expense in determining the carrying amounts of LIFO inventories for tax purposes, the benefit would be lost if it was not also considered acceptable for financial reporting purposes.

10. Some point out that acceptability for financial reporting purposes of simplified LIFO using 100% of the external index

would reduce the perceived accounting standards overload, by eliminating the need to maintain two separate sets of inventory records and the need for deferred income tax accounting. Some believe that acceptability for financial reporting purposes of simplified LIFO using 100% of the external index would encourage more companies to adopt LIFO, which some believe is conceptually superior to FIFO for financial reporting purposes.

11. Of those who believe simplified LIFO using 100% of an external index should be considered acceptable for financial reporting purposes, some believe it should be considered acceptable only if the external index structure and its application are reasonably representative of a company's experience. Others believe it should be considered acceptable unless it is apparent that the external index structure and its application do not reflect a company's experience. Still others believe it should be considered acceptable in all cases, without regard to a company's experience.

12. Against. Some believe simplified LIFO using 100% of the external index should not be considered acceptable for financial reporting purposes. They believe the use of 100% of an external index does not accomplish the goal of LIFO to reflect the effects of changing prices on the cost of sales for

a given company and that the indexes may not necessarily relate to a company's costs and inventory mix. Indeed, some question the integrity of a government generated price index. An error in the index, or in its application, could significantly distort the results of operations and financial position of a company having a limited variety of different inventory items. Also, some believe the IRS required conversion of the PPI from a price index to a cost index adds an unverifiable element of subjectivity. Others also believe simplified LIFO using 100% of the external index should not be considered acceptable for financial reporting purposes, because they believe financial accounting and reporting standards should not be based solely on tax rules, which may change.

Acceptability of Simplified LIFO
Using 80% of the External Index

13. For. The arguments for acceptability for financial reporting purposes of simplified LIFO using 80% of an external index are essentially the same as the arguments for acceptability of simplified LIFO using 100% of the external index. In addition, some believe that since LIFO and FIFO are both acceptable methods of inventory accounting, any approach whose results fall within the range of LIFO and FIFO should be considered acceptable. Indeed, present practice permits companies

that develop their own LIFO indexes to choose approaches that often produce significantly diverse inventory amounts. Accordingly, some believe it is anomolous to preclude certain companies from using a LIFO approach for financial reporting purposes that provides a reasonable result. Further, some believe that because 80% of the external index applies only to layer increments, the 80% approach when applied consistently is unlikely to significantly affect reported earnings.

14. Against. Some of the arguments against acceptability for financial reporting purposes of simplified LIFO using 80% of the external index are essentially the same as the arguments against acceptability of simplified LIFO using 100% of the external price index. In addition, some believe the results of applying 80% of the external index is neither cost nor market, which violates the historical framework of financial accounting and reporting. Also, because the criteria for the 80% and 100% are based on defined sales volume, two similar companies with identical inventory compositions could report significantly different ending inventory amounts if one company used 80% of the external index and the other used 100%.

Collateral Issue

15. If an enterprise uses simplified LIFO for tax purposes and another acceptable inventory method for financial reporting purposes that does not violate the LIFO conformity requirement, a collateral issue is whether the effect of the difference in tax and financial reporting methods should be accounted for as a timing difference under APB Opinion 11.

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Advisory Conclusions

16. The Accounting Standards Executive Committee and its Task Force on LIFO Inventory Problems believe

(a) simplified LIFO using 100% of the external index should be considered acceptable for financial reporting purposes unless it is apparent that the external index structure and its application do not reflect a company's experience. AcSEC: (7 agree, 3 disagree); Task Force: (6 agree, 2 disagree).

(b) simplified LIFO using 80% of the external index should not be considered acceptable for financial reporting purposes. AcSEC: (9 agree, 1 disagrees); Task Force: (5 agree, 3 disagree).

(c) if an enterprise uses simplified LIFO for tax purposes and another acceptable inventory method for financial reporting purposes that does not violate the LIFO conformity requirement, the effect of the difference should be accounted for as a timing difference under APB Opinion 11. AcSEC: (10 agree, 0 disagree); Task Force: (8 agree, 0 disagree).

Appendix A

IRS Regulations

→ *Caution: Reg. § 1.472-8 does not reflect Code Sec. 474 (¶ 2969) as added by P. L. 97-34.* ←

Example (2). (a) Assume the taxpayer in example (1) during the year 1962 completely disposes of item C and purchases item D. Assume further that item D is properly includible in Pool No. 1 under the provisions of this section. The closing inventory on December 31, 1962, consists of quantities at current-year unit cost, as follows:

Items	Units	Current-year unit cost Dec. 31, 1962
A	2,000	$6.50
B	1,500	6.00
D	1,000	5.00

(b) The taxpayer establishes that the cost of item D, had he acquired it on January 1, 1961, would have been $2.00 per unit. Such cost shall be used as the base-year unit cost for item D, and the LIFO computations at December 31, 1962, are made as follows:

		Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1962, inventory at current-year cost	
Item	Quantity	Unit cost	Amount	Unit cost	Amount
A	2,000	$5.00	$10,000	$6.50	$13,000
B	1,500	4.00	6,000	6.00	9,000
D	1,000	2.00	2,000	5.00	5,000
Totals			$18,000		$27,000

(c) Since the closing inventory at base-year cost, $18,000, is less than the 1962 opening inventory at base-year cost, $20,000, a liquidation of $2,000 has occurred during 1962. This liquidation is to be reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 1962, is $18,850, and is summarized as follows:

Pool No. 1

	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost *Percent*	Dec. 31, 1962, inventory at LIFO value
Jan. 1, 1961, base cost	$14,000	100.00	$14,000
Dec. 31, 1961, increment	4,000	121.25	4,850
Totals	$18,000		$18,850

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(3) *Use of inventory price index computed with reference to consumer or producer price indexes*—(i) *In general.* For purposes of paragraph (e)(1) of this section, for taxable years beginning after December 31, 1981, an inventory price index computed in the manner provided by paragraph (e)(3) will be accepted by the Commissioner as an appropriate method of computing an index, and the use of such inventory price index to compute the LIFO value of a dollar-value inventory pool will be accepted as accurate, reliable, and suit-

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[¶ 2963A]—Continued

able. A taxpayer using the inventory price index computation method provided by paragraph (e)(3) must use such method in determining the value of all goods for which the taxpayer has elected to use the LIFO method. However, the inventory price index computation method provided by paragraph (e)(3) may not be used by a taxpayer eligible to use inventory price indexes prepared by the United States Bureau of Labor Statistics for the purpose of valuing the LIFO inventories of a specific industry. Thus, a taxpayer eligible to use the retail price indexes prepared by the Bureau of Labor Statistics and published in *Department Store Inventory Price Indexes* may not use the inventory price index computation method provided by paragraph (e)(3). An inventory price index computed as provided by paragraph (e)(3) is computed in the manner provided by paragraph (e)(3)(ii) with reference to consumer or producer price indexes selected in the manner provided by paragraph (e)(3)(iii). Special rules for establishing inventory pools to be valued by an inventory price index computed in the manner provided by paragraph (e)(3) are in paragraph (e)(3)(iv). Rules relating to the adoption of, or change to, the method of computing an inventory price index in the manner provided by paragraph (e)(3) are in paragraph (e)(3)(v) and (vi).

(ii) *Computation of index.* An inventory price index computed in the manner provided by this (ii) shall be a stated percentage of the percent change in the selected consumer or producer price index or indexes for a specific category or categories of goods. The stated percentage for a taxpayer in a taxable year in which it is an eligible small business, as defined by section 474(b) of the Code, shall be 100 percent of the percent change in the selected price indexes. The stated percentage for all other taxpayers shall be 80 percent of the percent change in the selected price indexes. See paragraph (e)(3)(iii) of this section for rules relating to the selection of appropriate consumer or producer price indexes. Thus, if the selected consumer or producer price index for a specific category of goods increased 10 percent for the period December 1981 to December 1982, an inventory price index computed in the manner provided by this (ii) with reference to such consumer or producer price index will reflect an increase of either 10 percent for an eligible small business or 8 percent (80 percent of 10 percent) for all other taxpayers. If the selected consumer or producer price index for a specific category of goods increased 10 percent per year for the period December 1981 to December 1983, an inventory price index computed in the manner provided by this (ii) with reference to such consumer or producer price index will reflect an increase of either 21 percent for an eligible small business or 16.8 percent (80 percent of 21 percent) for all other taxpayers. If under paragraph (e)(3)(iii) it is necessary to select more than one specific consumer or producer price index for an inventory pool, the stated percentage of the percent change in such indexes is the stated percentage of the weighted average percent change for such indexes. Such weighted average is computed with reference to the relative amounts of costs in the inventory pool for each index category of goods. The costs to be used in computing such weighted average must be the relative current-year costs in ending inventory.

(iii) *Selection of consumer or producer price indexes*—(A) *In general.* An inventory price index computed as provided by paragraph (e)(3) of this section is computed with reference to the consumer or producer price

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indexes for specific categories of inventory items in the *CPI Detailed Report* or *Producer Prices and Price Indexes* published by the United States Bureau of Labor Statistics.

(B) *Selection of indexes by category of inventory items.* The selection of consumer or producer price indexes for an inventory pool is accomplished via a two-step process. First, the inventory items in each pool should be classified according to the detailed listings in the appropriate tables of the *CPI Detailed Report* or in *Producer Prices and Price Indexes* and assigned an index category. Second, an appropriate consumer or producer price index must be determined for each index category to which inventory items have been assigned. The assignment of index categories to the taxpayer's inventory items is accomplished by a process of elimination as follows:

(*1*) Whenever a specific inventory item in the taxpayer's inventory comprises 10 percent or more of total inventory value, such an inventory item must be placed in its own, separate index category. The index category selected must be the most detailed index category which includes that specific inventory item. In addition, any other inventory item that is included in such most detailed index category must also be included in such index category.

(*2*) If there are inventory items still remaining in the pool that have not been included in an index category, the taxpayer, beginning with the most detailed index categories for such remaining inventory items, must investigate successively less detailed index category levels and select the first index category that contains remaining inventory items which in the aggregate comprise 10 percent or more of total inventory value. The index category so selected must be the separate index category for the included inventory items. This procedure must be repeated either until all inventory items in the pool have been included in an index category, or until the remaining inventory items in the aggregate comprise less than 10 percent of total inventory value, or until it has been determined that no appropriate index category exists for the aggregate of such remaining inventory items.

(*3*) If there are inventory items remaining in the pool that comprise less than 10 percent of total inventory value, the index category to be selected for these inventory items must be the most detailed index category that includes such inventory items. If it has been determined that no appropriate index category exists for such remaining inventory items, such remaining inventory items must be combined in a miscellaneous index category created by the taxpayer.

In no event shall an index category be selected that is less detailed than either the 11 general categories of consumer goods described in Tables 3 and 5 of the *CPI Detailed Report* (see paragraph (e)(3)(iv) of this section), or the 15 general categories of producer goods described in Table 6 of the *Producer Prices and Price Indexes.* The determination of the appropriate index for an index category is accomplished as follows:

(*4*) Whenever an index category has been selected pursuant to paragraph (e)(3)(iii)(B)(*1*) of this section the appropriate index must be the published index for that index category.

(*5*) Whenever an index category has been selected pursuant to paragraph (e)(3)(iii)(B)(*2*) or (*3*) of this section, the appropriate

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index must be a weighted average of the published indexes of the index category items actually present in the taxpayer's inventory, excluding any index category items that have been placed in any other separate index category, weighted according to the weights used by BLS. Thus, if a taxpayer's inventory contains every inventory item that comprises the selected index category and none of these inventory items have been placed in any other separate index category, the appropriate index must be the published index for that index category. In the case of a miscellaneous index category created by the taxpayer, the appropriate index must be a weighted average of the published indexes for the index category items, weighted according to the weights used by BLS.

The use of BLS weights is limited only to the determination of the appropriate index for an index category. In computing the index for a pool, the taxpayer will weight the appropriate indexes for the separate index categories comprising the pool according to the taxpayer's actual inventory weights for such separate index categories. Whether the selection of the consumer or producer price indexes to be used to compute an inventory price index is appropriate, and the propriety of all computations incidental to the use of such consumer or producer price indexes, will be determined in connection with the examination of the taxpayer's income tax return. The selection of a consumer or producer price index for a specific good to compute an inventory price index under paragraph (e)(3) is a method of accounting. A taxpayer desiring to change the selection of such a consumer or producer price index must secure the consent of the Commissioner as provided in § 1.446-1(e). In the case of such a change, any layers of inventory increments previously determined and the LIFO value of such increments shall be retained. Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the inventory pool, the year of such change shall be used as the base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The base year costs of layers of increments in the pool at the beginning of the year of change shall be restated in terms of new base year costs using the year of change as the new base year.

(C) *Other selection requirements.* Manufacturers, processors, wholesalers, jobbers, and distributors may select indexes from only *Producer Prices and Price Indexes.* Retailers may select indexes from either the *CPI Detailed Report* or *Producer Prices and Price Indexes,* but if equally appropriate indexes could be selected from either publication, a retailer using the retail inventory method must select the index from the *CPI Detailed Report* and a retailer not using the retail inventory method must select the index from *Producer Prices and Price Indexes.* If a retailer using the retail inventory method selects a price index from *Producer Prices and Price Indexes,* the selected index must be converted into a retail price index. If a retailer not using the retail inventory method selects an index from the *CPI Detailed Report,* the selected index must be converted into a cost price index. Manufacturers, processors, wholesalers, jobbers, and distributors, must convert selected indexes into cost price indexes. In the case of the *CPI Detailed Report,* indexes may be selected only from Table 3 (Consumer Price Index for All Urban Consumers: Food expenditure categories, U. S. city average) and Table 5 (Consumer Price Index for All Urban Consumers: Nonfood expenditure categories, U. S. city average). In the case of the *Producer Prices and Price Indexes,* indexes may be selected only from Table 6 (Producer prices and price indexes for commodity groupings and individual items), un-

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less the taxpayer can demonstrate that the selection of an index from another *Producer Prices and Price Indexes* table would be more appropriate. In the case of a taxpayer using the retail inventory method, the selected index must be the index as of the last month of the taxpayer's taxable year. Taxpayers that do not use the retail inventory method must select indexes as of the month or months most appropriate to the taxpayer's method of determining the current-year cost of the inventory pool under paragraph (e)(2)(ii) of this section, or make a one-time binding election of an appropriate representative month during the taxable year. The election must be clearly set forth on Form 970 (see paragraph (e)(3)(v) of this section).

(iv) *Special rules for pools.* A retailer, wholesaler, jobber, or distributor computing an inventory price index in the manner provided by paragraph (e)(3) of this section may, at the option of the taxpayer, establish an inventory pool for any group of goods included within one of eleven general categories of consumer goods described in the *CPI Detailed Report.* The eleven categories are food and beverages, housing maintenance and repair commodities, fuels (other than gasoline), house furnishings and housekeeping supplies, apparel commodities, private transportation (including gasoline), medical care commodities, entertainment commodities, tobacco products, toilet goods and personal care appliances, and school books and supplies. Inventory pools that comprise less than 5 percent of inventory value may be combined to form a single miscellaneous inventory pool. If the resulting miscellaneous inventory pool itself comprises less than 5 percent of inventory value, such pool may be combined only with the largest inventory pool. See paragraphs (b), (c) and (d) of this section for additional rules relating to the establishment of pools. See also section 474 of the Code for rules relating to the use of a single pool by an eligible small business. Except as provided in paragraph (e)(3)(v) of this section, relating to the adoption or change of method of computing an inventory price index, the rules of paragraph (g)(1) and (2) of this section apply to a change in method of pooling.

(v) *Adoption or change of method.* The use of an inventory price index computed in the manner provided by paragraph (e)(3) of this section is considered a method of accounting. A taxpayer permitted to adopt or change to the dollar-value LIFO inventory method without first securing the consent of the Commissioner may also adopt the inventory price index computation method prescribed by paragraph (e)(3) incident to such adoption or change without first securing the consent of the Commissioner. In all other cases, a taxpayer may adopt or change to the inventory price index computation method prescribed by paragraph (e)(3) only after first securing the consent of the Commissioner as provided in § 1.446-1(e). However, in the case of a taxpayer not using the inventory price index computation method prescribed by paragraph (e)(3), the taxpayer may adopt or change to such method for the taxpayer's first or second taxable year beginning after December 31, 1981, without requesting the Commission's consent to such adoption or change. In addition, in such a case the taxpayer is not required to request the Commissioner's consent to a change in method of pooling incident to such adoption or change if the taxpayer is changing to a method of pooling authorized by paragraph (e)(3)(iv). In this case the rules of § 1.472-8(g) will apply. The inventory price index computation method provided by paragraph (e)(3) may be adopted and used only if the taxpayer indicates on a Form 970, or in such other manner as may be acceptable to the Commissioner, a listing of each inventory pool, the type of goods included in each

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pool, and the consumer or producer price index or indexes selected for each inventory pool. In the case of a taxpayer permitted to adopt or change to the inventory price index computation method without requesting the Commissioner's consent, the Form 970 shall be attached to the taxpayer's income tax return for the taxable year of such adoption or change. In other cases, the Form 970 shall be attached to a Form 3115 filed in accordance with § 1.446-1(e). Taxpayers must maintain adequate books and records of the use and computation of the inventory price index method in order to satisfy the requirements of § 1.472-2(h). Notwithstanding the rules in paragraph (e)(1) of this section, a taxpayer adopting or changing to the use of an inventory price index computed in the manner provided by paragraph (e)(3) is not required to demonstrate that the use of the double-extension method is impractical.

(vi) *Requirement incident to change.* In the case of a taxpayer using a method other than an inventory price index computed as prescribed by paragraph (e)(3) of this section to determine the LIFO value of a dollar-value inventory pool, any layers of inventory increments previously determined by such method and the LIFO value of such layers shall be retained if the taxpayer changes to the use of a price index computed as prescribed by paragraph (e)(3). Instead of using the earliest taxable year for which the taxpayer adopted the LIFO method for any items in the pool, the year of such change shall be used as the base year in determining the LIFO value of the inventory pool for the year of change and later taxable years. The base year costs of layers of increments in the pool at the beginning of the year of change shall be restated in terms of new base year costs, using the year of change as the new base year. See paragraph (f)(2) of this section for rules relating to a change to the dollar-value method from another method of pricing LIFO inventories.

Appendix B

External Indexes

Producer Price Index

The producer price index (PPI) was first reported in 1902 for the period 1890 to 1901. It covered 250 commodities. As of 1978, it covered 3,450 commodities based on 18,000 price quotes a month. By the mid-1980's, the index is expected to be based on 6,000 commodities using 90,000 price quotes.

Most price quotes are the selling prices of selected manufacturers and producers on an FOB production point basis. The information is provided by the companies confidentially and voluntarily. The Bureau of Labor Statistics (BLS) tries to have at least three companies provide price information on each covered item. A few prices are obtained from organized exchanges or central markets. The BLS selects the companies to include in the survey based on the "first significant commercial transaction." Pricing information is normally gathered as of the Tuesday of the week containing the 13th day of each month. No prices of imported goods are sampled.

If an item tested has had a significant physical change that affects its cost and, therefore, its price, one of two approaches may be taken: either the "new" item is substituted for the old one or the "new" price is adjusted to capture the change in price as if the goods were unchanged.

The monthly "price" used to determine the change is usually the unweighted average of the prices supplied by all companies that provide data on the item.

The BLS weights the index for each detailed category based on the category's relative proportion of total value of all commodities sampled. Those weights were last determined in 1972. They are not currently published.

The PPI is used, for example, for computing the GNP Implicit Price Deflator and for trade association studies.

Consumer Price Index

The consumer price index (CPI), reported monthly, is based on a fixed market basket of goods and services in the same monthly proportions. That is, no adjustment is made for consumer shifts to substitute goods or services whose prices have remained relatively stable. The basket of goods contains 250 general items. BLS "pricing agents" continually gather price information.

Prices are collected in 85 areas designated by the BLS. Indexes are published monthly and bimonthly for 28 specified cities, as well as the index for the U.S., which samples prices paid by 80% of the population, including all urban consumers.

Studies dealing with consumer expenditures (what is purchased), rent surveys (rental costs), and point-of-purchase (where the goods and services are purchased) support the price gathering.

The CPI is used, for example, for

- computing the GNP,
- escalation clauses in collective bargaining contracts,
- lease agreements - rent escalation clauses,
- royalties - escalation clauses, and
- alimony.