Woman C.P.A.

Volume 16 | Issue 3 Article 4

4-1954

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Recommended Citation

Gove, Eleanor T. and Howell, Margaret L. (1954) "LIFO Method of Inventory Valuation," *Woman C.P.A.*: Vol. 16 : Iss. 3 , Article 4.
Available at: https://egrove.olemiss.edu/wcpa/vol16/iss3/4

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LIFO METHOD OF INVENTORY VALUATION

By ELEANOR T. GOVE and MARGARET L. HOWELL

Eleanor T. Gove and Margaret L. Howell are First and Second Vice-Presidents of the Seattle Chapter of ASWA. Their discussion of the advantages and disadvantages of the LIFO method of inventory valuation was presented at the December, 1953, meeting of the Seattle Chapter.

Advantages of the LIFO method of valuing inventory—Eleanor T. Gove

Under present marketing conditions LIFO is beneficial to business from the standpoint of avoiding over-stating earnings. It makes no claim to substitute replacement cost for historical cost of sales, but simply matches the *latest* incurred costs against sales. With variations, LIFO can be adaptable to any business, but it is especially suitable for specialized types of businesses where the inventories lose their identities after they are acquired.

During these times of rising prices, profit shown on goods purchased at a lower price than today's prices and sold at the advanced prices is really a fictitious profit. Considering the fact that it is necessary to pay a much higher price for goods to replace those sold, it appears more logical to conclude that the added cost of maintaining inventories should be charged against the operations in the year it occurs. This method brings all prices to a current basis for profit and loss computation.

Since the inventory cost value has not been increased when the prices go up, there is no corresponding reduction needed when the prices go down. It is an obligation of the accountant to report profits on a strictly factual basis. The LIFO theory is that the most recent prices contain an element of inflation which should not be allowed to remain in the inventory accounts because the inflated value will not be realized until the items are sold.

In a long period of inflation, the real value of LIFO becomes apparent. Companies which have not been using the LIFO method have shown profits due to the increase in the valuation of their basic inventories. None of this increase has been realized, and, should prices level off, the increased capital required to carry the same inventories will have been classed as a realized profit. This would not actually be realized until such time as the inventories are reduced or eliminated.

Using current costs in comparison to current sales is the logical solution in arriving at *current* profits. Under this method, the inventories would be valued according to the earliest cost. Therefore, in a period of high prices, sales would be matched against high costs, and in a period of low prices, sales would be matched against low costs, thus stabilizing profits and protecting working capital.

Naturally, LIFO would have an effect on the Balance Sheet. It would be necessary to make adjustments so that it would coincide with the profit and loss statement. Showing assets and liabilities at current values, taking into consideration the depreciation and appreciation of plant assets, can be handled through accounts such as "Reserve to Prevent Capital Impairment". Standard costs could be used during the year for monthly statements, and at the end of the year adjustments made to arrive at inventory based on LIFO. The inventory consequently would be composed of the earliest purchases.

Probably too much emphasis has been put on the problem of accounting for profits, taxwise. The paying of dividends and profit-sharing are affected by whatever method is used in reporting net income. This necessity for paying stockholders according to reported profits, based on sale of goods which were bought at low prices and sold at inflated prices, could become a drain on the working capital of management. This could seriously affect their ability to repurchase goods at higher prices. Showing of higher profits on their statements also encourages bargaining agents to feel justified in asking for wage increases. LIFO should overcome this difficulty, and assist management in maintaining a stable business with adequate working capital.

Disadvantages of the LIFO method of valuing inventory—Margaret L. Howell

Last-in, first-out, or LIFO, is a method of valuing inventories at cost. In LIFO, it is *assumed* that the last goods purchased are the first sold. There may be times when this is the actual order of material usage, as when the last goods received may be issued first because they are on top of a pile or a bin, but usually this is not true.

The LIFO method leaves the oldest costs of a period more or less remote in the inventory.

The popularity of LIFO is often attributed to the tax advantage it confers. It did not become at all popular until the late 1930's, when the rate of federal income tax became sizable. At that time there was no averaging provision in the tax law, such as the carry-back or carry-forward of operating losses which we have today. Consequently, a firm paid high taxes on large profits during a favorable cycle, but could look forward to no relief or offset if net losses were suffered later. George O. May, CPA, in his book *Financial Accounting,* makes the following statements: "Altogether, the method has less usefulness than many of its adherents claim for it, and it is doubtful whether it would have gained its recent popularity but for the prospect of using it to reduce taxes in a period in which prices and tax rates were rising and the law was unjustly insistent on the false concept of each year as an entirely separate taxable unit. Now that the law has been amended so as to recognize the essential continuity of business and of the process of profit earning, and contains provisions for carrying losses forward or backward, the tax appeal of LIFO is greatly reduced and further extension of its use is not so probable as it seemed before those changes were made."

A deterrent to acceptance of the LIFO method is a provision in the income tax law that LIFO must be used for reporting purposes if it is to be used for tax purposes. No statements may be issued to partners, stockholders, or for credit purposes on an annual basis, using another inventory method, without disqualification. Interim statements, however, are permitted. It would appear that the authors of this requirement felt that a taxpayer should not be permitted to use a method of determining income subject to tax which he is unwilling to accept as clearly reflecting income for financial statement purposes. It has been suggested that the objection to the effect of LIFO on the balance sheet, namely, the over or understatement of the current asset inventory, is not so important because market value may be stated parenthetically. In an article in the June, 1953, issue of *Taxes,* Mr. Raymond A. Hoffman, CPA, writes about an instance where the SEC insisted that a registrant using LIFO should disclose the current market value of inventories. The registrant was agreeable providing that a ruling could be obtained from the Treasury Department to the effect that showing the current costs would not violate the code and disqualify the registrant from continued use of LIFO. The Treasury Department refused to issue such a ruling. "Accordingly, it was reasoned that taxpayers using the LIFO inventory method cannot afford to disclose in their accounts or reports, by means of a parenthetical note or otherwise, the inventories computed on any basis other than LIFO." Proponents of LIFO are, of course, requesting amendment of the regulations so that current replacement cost of the inventories may be shown on the balance sheet.

LIFO has been widely described as a means for eliminating "unrealized" profits in the inventory. The basis for this statement that imputes that profits under cost, or cost or market methods include "unrealized" and "unrealizable" profits is that the larger profits on a rising market under those methods are tied up in or are required to cover higher cost of inventories. The profits are not available for distribution if the business is to continue. In my opinion, the term "unrealized profits" is a misleading description of the situation. I found one writer who used the term "temporary" profits. In the view of Professor Moonitz, as expressed in the June, 1953, issue of *The Journal of Accountancy,* "Profit emerges not later than at the time of sale or collection from customer; reinvestment in similar items has no bearing on whether a profit was or was not realized on the investment and liquidation of items previously held."

The LIFO method tends to equalize periodical profits during a cycle of years in which prices rise and fall. This effect is often mentioned but never stressed. Equalization of income is not a proper accounting objective. It is stated in *Accounting Research Bulletin No. 32,* "An important objective of income presentation should be the avoidance of any policy of income equalization." The equalization under LIFO results, of course, from matching latest costs incurred with current revenues. When prices are high, matching latest high costs with current revenues yields less profit; and when prices are low, matching latest low costs with current revenue yields more profit.

Sometimes LIFO is said to present a more realistic profit. However, since business cycles have been with us for a long time and will probably continue to be with us, methods of recognizing them would seem

to be more realistic than those which do not.

LIFO theory assumes a certain minimum amount of inventory which must be on hand at all times to permit normal operations. Inventory above this minimum is necessary to fill current-period sales and is charged out at current purchase cost. During the war emergency, 1941-47, part of this basic or normal LIFO inventory was commonly liquidated. As Moonitz points out, "It is significant that liquidation occurred even among companies which had asserted their basic or normal LIFO inventory was essential to operations, that it was 'fixed' by technical considerations and could not be liquidated without suspension of activity. Still they continued to operate, and on a high level. It is also significant that these companies were not willing to take the consequences, taxwise, of their use of low-valued inventories in a period of high prices. The result was an extension of LIFO to include 'next-in, first-out' to permit the deduction of the costs of units subsequently acquired from revenues previously realized and wholly unrelated to the replacement of the 'involuntarily-liquidated' basic stock." Professor Moonitz's remark about NIFO, next-in, first-out, refers to legislation which was passed to alleviate the distress LIFO users found themselves in when their inventories were involuntarily liquidated due to conditions beyond their control which arose as a result of the war emergency. It is now being proposed that a similar relief provision be enacted applicable to liquidations of inventory quantities attributable to other causes, such as labor difficulties at taxpayer's plant or at the plant of a supplier, fire, flood, inclement weather, and so forth. Because of the difficulty of defining such involuntary liquidations completely, it has been suggested that the statute be amended to permit taxpayers to have all decreases in LIFO inventories subject to replacement within a certain period, such as five years. It is pointed out that this would "remove the disturbing economic conditions in some markets where the principal members of an industry are making abnormal purchases at the same time to build up inventory quantities which were temporarily diminished."[1] Prices have actually risen in some markets because LIFO users were making purchases to avoid having inventory quantities at the end of the year below those at the beginning of the year. There are also cases where businessmen have deferred making shipments of merchandise for the same reasons. As you know, when a year-end inventory falls below the former basic minimum, the "reservoir" level is permanently reduced.

The Internal Revenue Code does not permit the write-down of LIFO inventories to market where market is lower than the LIFO inventory cost. Legislation will be presented again this next session to legalize the write-down of LIFO inventories to market. Although many accountants apparently are not bothered by an understatement of inventories in the balance sheet, it would appear that substantial over-valuation of inventories in the balance sheet would require a qualified report. Substantial over-valuation of inventories could occur if prices should decline considerably. This fear of declines in prices below costs prevailing on the basic LIFO date is undoubtedly the greatest deterrent to a more widespread adoption of LIFO. It is suggested that legislation to permit the write-down of LIFO inventories to market would place LIFO taxpayers who adopted LIFO at a time of comparatively high prices substanially in the same position as competitors using LIFO with a lower price level as a starting point. Such legislation is also desired because it is generally recognized to be unrealistic to carry inventories in financal statements at an amount exceeding market value. The people who advance this theory have not been so bothered about the realism of an inventory substantially understated in the balance sheet. It seems that some of the disadvantages of LIFO are about to be overcome through legislation.

In his article *Lifo-or-Market-Plan,* in the January, 1953, issue of *Accounting Review,* K. Engelmann points out that "If the proposed amendment should become law, inconsistency through changing methods when the trend changes would be legalized; it should be clearly understood that the right to adjust the inventory price level downward to lower market values does not represent a mere modification of LIFO; it is a complete reversal of the method for the year at the end of which the adjustment is made." Mr. Engelmann goes on to say, "The amended LIFO method, which some writers call LIFO OR MARKET WHICHEVER IS LOWER, would better be characterized as LIFO OR NON-LIFO, WHICHEVER IS MORE CONVENIENT FOR TAX PURPOSES. If adopted, the Internal Revenue Code would favor a principle of expediency to dominate one of the most important fields of accounting, in contrast to the principle of consistency which is one of the main prerequisites of every sound accounting system."

[1] Hoffman, Raymond A., June, 1953, *Taxes.*