

If it (IPIC LIFO method) is good enough for the IRS, it should be good enough for GAAP

Background

According to the Internal Revenue Code, a taxpayer using the LIFO method for tax purposes must also use the LIFO method in their financial statements. However, the IRS does not stipulate that taxpayers using the LIFO method for tax purposes must use the same LIFO method in their financial statements.

There are two principal ways that a taxpayer may compute its LIFO inventory for tax purposes: i) an external index method, referred to as the IPIC (Inventory Price Index Computation, a.k.a. "Simplified LIFO") method; and ii) an internal indexing method, such as the link-chain method or double-extension method. In our experience, the majority of privately-held companies using the IPIC method for tax purposes also use this method for their financial statements. However, many public companies using LIFO and IPIC for tax purposes are not able to use IPIC for their financial statements. While it is not generally a company's preference to use two different LIFO methods for tax and financial accounting purposes, that choice is forced on many companies because their auditors tell them that the use of the IPIC method is not acceptable for GAAP.

The reason some auditors consider that the IPIC method is not acceptable for GAAP is based on an Issues Paper published by the Accounting Standards Division of the AICPA dated October 14, 1982, entitled *The Acceptability of Simplified LIFO for Financial Reporting Purposes*. The last paragraph of this paper (paragraph 16) states:

"The Accounting Standards Executive Committee and its Task Force on LIFO inventory problems believe:

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."

7 of 10 AcSEC members agreed with this statement. 6 of 8 Task Force members agreed with this statement.

While in theory that statement seems to support the use of IPIC for financial reporting, as well as for tax purposes, in practice that statement is viewed as a bar to the use of the IPIC method for financial reporting purposes. The reason that statement is considered a bar to the use of IPIC for financial reporting purposes is that companies are not able to demonstrate that their use of IPIC for financial reporting purposes is consistent with their inflation experience unless they perform an entirely separate LIFO calculation based on an internal index method.

The reason for that practice is that the Issues Paper does not provide any guidance about what “...unless it is apparent that the external index structure and its application do not reflect a company’s experience” means in application. Does the pro forma internal index inflation need to be within 1% of the IPIC inflation or is the acceptable difference more or less than this? Moreover, it is uncertain whether the inflation difference between the two methods must be compared on an annual basis or over several years and if so, how many years?

Because no guidance was provided to address these refinements, the CPAs that consider this Issues Paper to be definitive GAAP guidance generally think that this inflation comparison needs to be made every year. Moreover, the practical effect of that interpretation is that even though a company wants to use IPIC for GAAP and ends up using IPIC for GAAP, they are forced to make an internal index calculation every year in addition to the IPIC method calculation in order to be able to compare the results of the two methods. While it could be argued that a full internal index calculation as an alternative financial statement calculation is unnecessary and that an estimate of internal inflation would suffice, anyone with substantial LIFO experience would tell you that unless the internal index estimation calculation was performed with precision by someone with at least hundreds of hours of LIFO experience (these people are few and far between), such an estimate would most likely not be reliable.

From a purely theoretical perspective and notwithstanding the fact that this major question was ignored, the Issues Paper guidance makes sense. How can one seriously argue that the use of nationwide government price indexes for the various types of items included in inventory is a preferable LIFO inflation measurement method compared with the measurement of a company’s LIFO inflation using the company’s inventory records.

Problems posed

What the Issues Paper failed to address was the qualitative aspect of an internal index calculation. In actual practice, the steps required to make an accurate and reliable internal index calculation are often much more complicated than an IPIC method LIFO calculation and substantial LIFO experience is required in these cases to reliably measure internal index inflation. However, companies thought they were avoiding the need to make such detailed internal index computations when they adopted the IPIC method for tax purposes.

Our firm has substantial internal index calculation experience and I spent over 1,000 hours developing an internal index calculation module that is now part of our LIFOPro software. Internal index calculations are straightforward and not terribly complicated for some companies. For a retailer (assuming they do not use the Retail Inventory Method) or wholesaler with a single or a small number of locations, if the inventory detail records are well organized, what we would consider to be accurate and reliable LIFO index calculations can be made without much effort (especially if an internal index calculation program is used and not just an Excel template). However, there are many companies for which the

internal index calculation is much more complicated and prone to error. In addition, aspects of the LIFO calculations are much more difficult with respect to the issues described below:

1. **New items – These are defined as items for which the current year end quantity on hand is greater than zero but for which none of these items were on hand the previous year.** IRS and other GAAP guidance (Issues Paper published by the Accounting Standards Division of the AICPA and dated November 20, 1984 entitled *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*) for these items is that estimates can be made of what the prior year item cost would have been and the term used for this is “reconstruction” of the prior year end item cost. It is not permissible as per the IRS Regs. or for GAAP to ignore the new items and measure inflation only using non new items. What is permissible as per the IRS Regs. and for GAAP is to set the prior year end item cost equal to the current year end item cost for new items which means there is zero inflation for all new items. A company would want to shy away from using this method for tax purposes because this understates LIFO inflation but this is the method most companies use for GAAP because this understates LIFO inflation. What this means for a company for which the inventory item turnover rate is 20% a year (20% of all items each year are new items) is that their LIFO inflation is automatically either understated or overstated by 20%.
2. **Purchase price variances (PPV) for manufacturers using standard costs** – For these companies, internal indexes are calculated by comparison of the current year standard cost per item to the prior year end standard cost. An accurate measurement of inflation for this type of situation should entail consideration of the portion of the PPV that is applicable to the ending inventory (referred to as the capitalized PPV). When there is substantial inflation or deflation during a year, exclusion of the PPV component can significantly overstate or understate the proper amount of inflation. However, for tax purposes, under some uniform capitalization methods, a company’s PPV may be excluded from the internal index calculation. We have seen multiple situations for which this has happened. The PPV for the prior year needs to also be considered however it is not appropriate to use the dollar amount of the prior year capitalized PPV dollars as an item in the prior year extended cost column because the prior year end PPV dollars are applicable to the prior year end inventory mix and not the current year. If those making this calculation do not know how to properly deal with this mathematically, this can cause a misstatement of the actual inflation or worse yet, the PPV may not be considered at all.
3. **Consideration of trade discounts** – These discounts often represent significant amounts and if they are not properly considered, the inflation could be misstated. However, the adjustment for these discounts is typically calculated as a “top side adjustment” because such discounts are usually not a reduction of the item cost value in the inventory accounting system.
4. **The use of sampling methods** – Many companies with numerous locations use sampling methods to reduce the amount of work required but the result is an estimate of a company’s inflation using only a portion of their inventory and the quality of the

results will correlate to the amount of experience for those making the sampling method decisions.

5. **Treatment of outliers** – Accurate internal index calculations require analysis of inflation and deflation outliers (inflation or deflation above a certain threshold, e.g. 30% for an individual item). Outliers may signal a mistake in a company's records, such as a change in the unit of measure from one year to the next but also because of inaccuracies in item cost values. Substantial time may be required to determine which outliers are to be excluded from the index calculation. Some companies do not review outliers and some simply exclude all outliers that exceed a certain threshold.
6. **Retailers using RIM** – The use of an internal index calculation method for retailers using the retail inventory method (RIM) is problematic because perpetual inventory records are not maintained. An internal index calculation for a company using RIM would entail an estimation process on a sampling basis. We have seen situations for this type of company for which the internal index inflation was calculated using only the warehouse inventories and store inventories are completely excluded from the calculations.

It is not uncommon for companies to use internal index calculation methods that the IRS regards as impermissible. These methods are considered as such because they are not reliable methods to use for measuring LIFO inflation. The most common of these methods include:

1. **Improper item definition** - Many companies use what we refer to as equivalent items or units. Instead of using actual inventory items, pounds or some other unit of measure is used. It is not uncommon for a company selling metal products to use the average cost per pound to compare LIFO inflation from year to year. They build a LIFO layer history schedule using pounds instead of dollars as the inventory at base prices value. This is an impermissible method even if multiple pools are used for different types of metals because this is an estimate of LIFO inflation the IRS considers not to be reliable because inventory items are defined too broadly to accurately measure inflation.
2. **Not measuring inflation for overhead and labor for manufacturers** – Manufacturers not using a standard cost system (for which labor and overhead costs are included in the item cost) will often measure LIFO inflation using only the raw material component of the item cost values and the labor and overhead components of item cost are ignored. Alternatively, companies may use a so-called components-of-cost method to compute the inflation on labor and overhead. These are not permissible approaches to the IRS because they conflate inflation with technological efficiencies with inflation or they assume that the labor and overhead inflation is the same as the raw material costs. In past years, this caused many manufacturers to exclude labor and overhead costs from their LIFO election scope. Many of these companies expanded their LIFO election scope to include labor and overhead when they switched to the IPIC method for tax purposes (because PPI and CPI indexes measure the total price) but for financial statement purposes use the raw materials inflation for labor and overhead also.

3. **Use of manufacturers price books for equipment retailers** – Companies in this business use specific identification as the current-year cost method and do not use SKUs as do other companies which makes the use of a normal internal index calculation method impossible. Some of these companies use a comparison of costs for common equipment models between years by reference to a manufacturer's price books. This LIFO inflation estimation method is not permissible to the IRS and the use of the IPIC method is the only practical method for such companies.
4. **Use of the double-extension method** – At present, the use of this method for which prices are compared from the current year back to the base year instead of to the prior year is permissible to the IRS. We are concerned that the IRS may eventually consider this an impermissible method because this method does not accurately measure inflation. This method measures inflation as adjusted for the change in inventory mix from one year to the next, which means that it can be an unreliable estimate of inflation and this fact is well known to those with substantial LIFO experience. The use of this method is also not practical because using this method requires companies to determine what the unit cost for an item would have been 50 years ago or for however long LIFO has been used.

Because of practical difficulties, some companies use the methods described above for financial statement purposes even though these methods are impermissible for tax purposes. They support that approach because there is no LIFO GAAP guidance that specifically prohibits the use of these methods. There was no need for GAAP guidance about this prior to 1980. Before 1980, the IRS "conformity rule" portion of the IRS Regs. required companies to use the same LIFO method for financial statements as is used for tax purposes. The conformity rule was changed in 1980 to allow companies to use a different LIFO method for financial statements than is used for tax purposes. However, the tax regulations do not stipulate what LIFO method a taxpayer must use for financial reporting purposes.

All the problems with the use of internal index calculation methods described above would be solved if companies were permitted to use the IPIC method for financial reporting purposes. The use of the IPIC method does not require substantial LIFO experience. The most important aspect of the ability to make a reliable measurement of LIFO inflation when using this method is the assignment of appropriate PPI or CPI commodity codes to inventory items. The requirement to possess substantial experience to properly deal with the laundry list of ways in which an internal index calculation can become unreliable is not necessary when the IPIC method is used.

The IRS wrote regulations to establish the use of the IPIC method in 1984. The reason the IPIC Regs. were written was to provide a less complicated and error prone LIFO method for taxpayers and CPAs to use. The IRS was aware of the many ways in which internal indexes can become unreliable. Not only did the IRS permit the use of the IPIC method starting in 1984, the IRS also probably considers the IPIC method to be a preferable LIFO calculation

method to the use of internal indexes for tax purposes. This interpretation can be inferred from the following points:

1. A change to the IPIC method is an automatic approval method change requiring no advance consent.
2. IRS audit protection is provided to a taxpayer when changing to the IPIC method. This audit protection means that once a change to the IPIC method is made, the IRS cannot propose audit adjustments for years prior to the change to use the IPIC method.
3. A change to an internal index method from the IPIC method is not an automatic approval method change.
4. When the IRS deems a taxpayer's LIFO calculation documentation to be unreliable now or in the past (inadequate books and records is their term for this situation) while using an internal index method, the IRS often will make what it refers to as an "involuntary change to the IPIC method". When the IRS does this, it will make a pro forma calculation of all prior years' LIFO calculation using the IPIC method and the proposed audit adjustment will be based on this calculation.

The 1982 AICPA Issues Paper referenced above was written two years before the IPIC LIFO Regs. became final because the AICPA was aware of the proposed IPIC Regs. and anticipated the question of acceptability of the IPIC method for financial statement purposes. We believe that their Issues Paper was a good faith attempt to address this issue but because the qualitative aspects of LIFO internal index calculations were ignored, the Issues Paper conclusion should no longer be considered authoritative GAAP and that the use of the IPIC method should be considered acceptable for GAAP provided that the guidance provided in the IRS LIFO Regs. for the use of the IPIC method is followed.

In some cases, the use of an external index method is deemed to be preferable for financial statement purposes because a company makes a judgement that the use of an internal index is impracticable. This happens on occasion and we believe this is a reasonable position for many companies but the process of making this determination can be very time-consuming and costly. The ability to determine the quality of an internal index calculation requires substantial LIFO experience and these people are few and far between. We believe that the best solution to these problems is to rescind the conclusion arrived at in the 1982 Issues Paper. Doing so will:

1. Eliminate the situation that now exists for which most companies and CPAs do not follow the guidance of the Issues Paper and a minority of companies follow this guidance.
2. Eliminate the substantial extra time and cost required to make LIFO calculations using two different methods.
3. Eliminate the need for anyone to pass judgement about the qualitative aspects of internal index calculations.