

THE LIFO COALITION

1725 K Street N.W., Suite 300, Washington, DC 20006 • TEL: 202-872-0885

June 26, 2006

The Honorable Charles E. Grassley
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Max Baucus
Ranking Member
Senate Committee on Finance
511 Hart Senate Office Building
Washington, D.C. 20510

Re: *Last-In, First-Out (LIFO) Inventory Method*

Dear Chairman Grassley and Senator Baucus:

On behalf of the LIFO Coalition, an *ad hoc* group of over 50 trade associations representing hundreds of thousands of separate businesses, we are pleased to offer a memorandum, addressed to the Coalition and in response to the testimony of Professor George A. Plesko, University of Connecticut School of Business, concerning the last-in, first-out (“LIFO”) inventory method, presented at a hearing before the Senate Finance Committee on June 13, 2006. We request that this memorandum, as our statement on the issue, be made a part of the official record of that hearing.

We respectfully submit that the testimony by Professor Plesko was seriously inaccurate. To this effect:

- Professor Plesko’s testimony significantly understates the use of LIFO by the U.S. business community and the very substantial adverse effect of repeal on the U.S. economy, with such inaccuracies based in part on inclusion of irrelevant data and failure to recognize accounting protocols that create differences between statements of book and tax LIFO reserves;
- The testimony fails to recognize the efficacy of the LIFO method in measuring financial condition and in calculating tax liability for a wide variety of industries that experience perennial increases in costs of inventory and production;
- The testimony greatly exaggerates the potential for manipulation of taxable income under the LIFO method, and fails to recognize rulings of the Internal Revenue Service and case law endorsed by the U.S. Supreme Court that specifically address any such potential abuses; and,
- The testimony asserts that businesses would not use LIFO for financial accounting purposes but for the tax savings and the conformity requirement, thus begging the tax policy question of LIFO accounting as an appropriate means of measuring economic income for both book and tax purposes (and further failing to acknowledge that repeal of LIFO and forced adoption of “FIFO” would misstate book and tax earnings for businesses subject to rising inventory costs, and moreover, that the FIFO method provides an advantageous tax outcome for those businesses with declining costs of inventory and production).

The LIFO Coalition

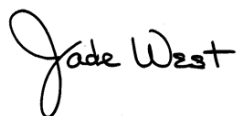
June 26, 2006

Page 2

The memorandum to the LIFO Coalition is provided by Leslie J. Schneider. Mr. Schneider is a senior member of a Washington law firm that specializes in tax issues. He is author of a standard treatise on income tax accounting, published since 1979 by Matthew Bender/Lexis-Nexis. He has taught income tax accounting as adjunct professor in the graduate tax program at Georgetown University Law Center. Mr. Schneider earlier served in the Treasury Department with duties in the offices of Tax Policy and Tax Legislative Counsel. In addition to membership in the Bars of the District of Columbia and Maryland, Mr. Schneider is a licensed certified public accountant.

A list with membership in the LIFO Coalition appears below.

Sincerely,



Jade West, Executive Secretariat, The LIFO Coalition
Senior Vice President-Government Relations, National Association of Wholesaler-Distributors

cc: Members of the Finance Committee
Tax Policy Head, Treasury
Chief of Staff, Joint Tax Committee

MEMBERSHIP OF THE LIFO COALITION:

American Chemistry Council
American Forest & Paper Association
American Gas Association
American Institute of Certified Public Accountants
American International Automobile Dealers Association
American Supply Association
American Wholesale Marketers Association
Americans for Tax Reform
API
Associated Equipment Distributors
Association for Hose & Accessories Distribution
Association of Equipment Manufacturers
Business Roundtable
Copper & Brass Servicenter Association
Far West Equipment Dealer's Association
Food Marketing Institute
FreedomWorks
Gases & Welding Distributors Association
Healthcare Distribution Management Association
Heating, Airconditioning & Refrigeration Distributors International
Independent Lubricant Manufacturers Association
Independent Sealing Distributors
Industrial Supply Association
International Foodservice Distributors Association
International Franchise Association
International Sanitary Supply Association

The LIFO Coalition

June 26, 2006

Page 3

Iowa Nebraska Equipment Dealers Association
Iowa Nebraska Equipment Distributors
Metals Service Center Institute
National Association of Manufacturers
National Association of Sporting Goods Wholesalers
National Association of Wholesaler-Distributors
National Automobile Dealers Association
National Beer Wholesalers Association
National Federation of Independent Business
National Grocers Association
National Marine Manufacturers Association
National Petrochemical & Refiners Association
National Retail Federation
National Roofing Contractors Association
National RV Dealers Association
National Truck Equipment Association
North American Equipment Dealers Association
Outdoor Power Equipment Aftermarket Association
Petroleum Equipment Institute
Printing Industries of America, Inc.
Retail Industry Leaders Association
S Corporation Association
Small Business & Entrepreneurship Council
SouthWestern Association
Southeastern Equipment Dealers Association
The State Chamber-Oklahoma's Association of Business and Industry
Textile Care Allied Trades Association
U.S. Chamber of Commerce
Wholesale Florist & Florist Supplier Association
Wine & Spirits Wholesalers of America
Wood Machinery Manufacturers of America

IVINS, PHILLIPS & BARKER

CHARTERED

1700 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006-4723

TELEPHONE (202) 393-7600
FACSIMILE (202) 393-7601
(202) 347-4256

IPB@IPBTAX.COM
WWW.IPBTAX.COM

JAMES S.Y. IVINS (1885-1960)
PERCY W. PHILLIPS (1892-1969)
RICHARD B. BARKER (1906-1988)

OF COUNSEL

JAY W. GLASMANN
STEPHEN N. SHULMAN
WILLIAM L. SOLLEE
DANIEL B. STONE
CLIFTON B. CATES III
ERIC D. CHASON

LOS ANGELES OFFICE
1925 CENTURY PARK EAST
SUITE 2140

LOS ANGELES, CALIFORNIA 90067
TELEPHONE (310) 551-6633
FACSIMILE (310) 551-1188

H. STEWART DUNN, JR.
CARROLL J. SAVAGE
ERIC R. FOX
CAROL K. NICKEL
ALAN WINSTON GRANWELL
LESLIE JAY SCHNEIDER
ROBERT H. WELLEN
KEVIN P. O'BRIEN
JOSEPH DECARLO, JR.*
PATRICK J. SMITH
MICHAEL R. HUFFSTETLER
LAURIE E. KEENAN
JEFFREY E. MOELLER
STEVEN H. WITMER
ROSINA B. BARKER
WILLIAM L. SOLLEE, JR.
JODI H. EPSTEIN
ROBIN M. SOLOMON
DIRK J.J. SURINGA
ROBERT G. LORNDALE, JR.
H. CARTER HOOD

*NOT ADMITTED IN THE DISTRICT OF COLUMBIA

JUNE 26, 2006

DAVID D. SHERWOOD
JENNIFER J. FINN
DANIELLE E. ROLFES
LISA MILOT
SARAH S. MCGONIGLE
JONATHAN ZIMMERMAN
VICTOR S. CHANG
JAMIE E. BROWN*

MEMORANDUM

TO: The LIFO Coalition

FROM: Leslie J. Schneider

RE: A Response to Testimony by Professor Plesko

Background and Summary

As requested by the LIFO Coalition, as follows is a response to testimony delivered before the Senate Finance Committee by Professor George A. Plesko, at hearings held June 13, 2006. Professor Plesko's testimony largely concerned the "last-in-first-out" or "LIFO" accounting method.

In sum, I submit that Professor Plesko's testimony significantly understates the breadth of use of the LIFO method and likewise understates the substantial adverse impact on capital investment that would result from the repeal of LIFO for tax purposes. Moreover, Professor Plesko's testimony fails to recognize the well-established merits of LIFO for financial accounting purposes, and overstates potential abuse of the method for tax accounting purposes.

More to this effect, Professor Plesko's testimony fails to address the fundamental issue with respect to any method of accounting, as applicable either to financial record keeping or calculation of tax liability: Does use of the accounting method clearly reflect income? In this regard, more than 60 years' experience shows that the LIFO method clearly reflects income.

I find that statistics offered by Professor Plesko in support of his conclusions make selective use of data, such that the use of LIFO by the business community is very substantially understated. This results in a correspondingly substantial understatement of the adverse economic effects to the U.S. economy from LIFO repeal. Moreover, Professor Plesko suggests abusive potential of the LIFO method without recognizing a body of substantive law addressing any such abuses, as ultimately endorsed by the U.S. Supreme Court.

I submit that a more balanced evaluation of the LIFO method by the Senate Finance Committee would reveal the efficacy of the LIFO method in determining book and taxable income, the central importance of LIFO to capital formation, and the drastic adverse impact on U.S. businesses that would result from its repeal.

Detailed Analysis

1. Extent of Use of LIFO

If the propriety of the continued permissibility of the LIFO inventory method for federal income tax purposes is a subject that is going to be reconsidered, I believe that any reconsideration of this question should be based on the most accurate available information concerning the extent of the use of the LIFO inventory method and the potential impact on U.S. businesses of the repeal of LIFO for tax purposes.

A major focus of Professor Plesko's testimony was the question of the extent of the use of the LIFO inventory method among businesses in the United States. Since information on this subject from the perspective of federal income taxes is not publicly available, Professor Plesko relied on information on the use of LIFO from a financial reporting perspective to draw conclusions about the extent of the use of LIFO for tax purposes.

The conclusions that Professor Plesko reached and presented in his testimony, based on the financial reporting data that he examined, are that the LIFO inventory method is not widely used by U.S. businesses, that the use of LIFO is declining, and that the inventories for which the LIFO method is used make up a relatively small percentage of the total inventories held by businesses in the United States. Thus, the implication of Professor Plesko's testimony is that the repeal of the LIFO method for federal income tax purposes would not have a significant impact on American businesses.

I submit that the foregoing conclusions by Professor Plesko concerning the prevalence of the use of LIFO and the impact of a repeal of LIFO for tax purposes are totally inaccurate for a number of reasons. Contrary to Professor Plesko's conclusions, the use of the LIFO method is far more prevalent than his analysis suggests, and, as a consequence, the repeal of LIFO for tax purposes would have a profoundly damaging effect on a very large number of businesses in a wide range of industries.

It should be noted, as a preliminary matter, that in his testimony, for purposes of evaluating the effect of the potential repeal of the LIFO method for tax purposes, Professor Plesko relied to a large extent on the only publicly-available data that exists on the subject of the accounting methods used by U.S. businesses, which is set forth in *Accounting Trends & Techniques*. This is an annual publication of the American Institute of Certified Public Accountants ("AICPA"), which surveys the financial reporting practices of a sampling of 600 of the Fortune 1000 largest publicly-owned businesses in the United States. Professor Plesko analyzed the data in this publication for a number of years and concluded that the percentage of the businesses in this sample that used LIFO for a majority of their inventory had decreased from 43 percent in 1985 to 21 percent in 2004. However, Professor Plesko overlooks the fact that there are a number of reasons why these percentages significantly understate the extent of LIFO usage.

The first reason why Professor Plesko's analysis and conclusions understate the prevalence of LIFO usage is that there are many industries in which inventories in the conventional sense are not needed as part of the operation of the business. Therefore, the LIFO inventory method could not possibly be used in these industries either for tax or financial reporting purposes. For example, companies operating in the service sector of the economy, such as advertising, computer and data services, telecommunications, transportation, etc., do not ordinarily sell merchandise to customers. The first industry listed in Professor Plesko's Table 1 is "Advertising marketing." Businesses in the advertising and marketing industry obviously have no need for inventories as part of their business operations, and the same is true of a number of the other industries listed in Professor Plesko's Table 1. Such companies with no inventories may nevertheless have large quantities of operating supplies, and, as is shown in *Accounting Trends & Techniques*, businesses will frequently classify such operating supplies as inventory, although such items are not permitted to be valued on the LIFO method either for tax or financial reporting purposes. In addition, in a number of industries, such as construction, aerospace, etc., businesses classify as inventory in their balance sheets work-in-process that is required to be accounted for on the percentage of completion method for tax purposes. This type of work-in-process that is required to be accounted for on the percentage-of-completion method is ineligible for the LIFO method.

In fact, from a review of the industries represented by the *Accounting Trends & Techniques* sample, approximately 25 percent of the business entities in the sample of 600 operate in industries where the LIFO method could not be used, either because there is no need for inventories as part of the business operations or because the inventories are ineligible for the use of LIFO by reason of being required to be accounted for on the percentage-of-completion method. When the percentage of businesses using LIFO is computed based on the smaller sample of businesses (approximately 450) that both have true inventories and are not prohibited from using the LIFO method for such inventories by reason of the mandatory use of the percentage-of-completion method, the percentage of LIFO users increases to a majority of the eligible businesses (approximately 239 businesses). This same analysis should also be applied to Professor Plesko's conclusions about the number of businesses that use the LIFO method for a majority of their inventories. Even for businesses operating in industries where conventional inventories are maintained and LIFO is used to account for such inventories, those businesses may also hold significant quantities of operating supplies that may be classified as inventories in the balance sheet but for which the LIFO method is not permitted. Moreover, most large U.S. businesses have significant overseas operations carried on by foreign affiliates and the inventories held by these foreign affiliates are not eligible for the LIFO method. However, these inventories of foreign affiliates are required to be included in the businesses' consolidated U.S. financial statements along with the inventories associated with U.S. operations, even though these inventories of foreign affiliates are not ordinarily required to be reflected on U.S. consolidated tax returns since the foreign affiliates are not subject to U.S. income tax.

Similarly, among smaller, non-publicly-held businesses, discussions among the membership in the LIFO Coalition suggest that a much higher percentage of businesses use the LIFO method than is presented in Professor Plesko's testimony. For example, anecdotal reports suggest that approximately 75 percent of U.S. automobile dealers use the LIFO method. I also know that LIFO is widely used by equipment dealers, wholesaler-distributors, manufacturers and retailers. Accordingly, I submit that the repeal of the LIFO method would have a widespread impact on a very large number of small and medium size businesses, as well as larger businesses, in numerous industries throughout the United States.

In conclusion, I submit that the use of LIFO is much more widespread than is suggested by Professor Plesko's analysis, and, to the extent that LIFO is used for only a portion of a particular business's inventories, that limitation is due mostly to the unavailability of the LIFO method in those situations, rather than being due to a preference for the FIFO method.

2. Dollar Impact of Repeal of LIFO for Tax Purposes

Another significant aspect of Professor Plesko's analysis is his attempt to estimate the aggregate amount of potential revenue that would be raised by the repeal of LIFO for tax purposes. This revenue is represented by the aggregate difference between the value of each business's inventory on the LIFO method and what those inventories would be valued at if the FIFO method were used. This difference is commonly referred to in businesses' balance sheets as the "LIFO reserve." Professor Plesko estimates that the aggregate LIFO reserve of U.S. businesses using the LIFO method is approximately \$60 billion. He bases this estimate on extrapolations from limited published data from publicly held businesses' financial statements. Professor Plesko then applies a hypothetical tax rate of 30 percent to this estimated aggregate LIFO reserve to measure the potential tax impact of repealing LIFO.

Here again, Professor Plesko demonstrates his limited knowledge of the LIFO method. Examining the LIFO reserves that businesses report for financial reporting purposes, particularly larger publicly-held businesses, does not give an accurate measure of what those same businesses' LIFO reserves would be for tax purposes. The LIFO reserves for tax purposes tend to be larger than the LIFO reserves for financial accounting purposes. The main reason for the difference between book LIFO reserves and tax LIFO reserves is that under financial accounting principles (A.P.B. No. 16), when one business acquires another business in any type of acquisition transaction (including mergers), the carrying value of all of the assets of the acquired business (including any inventories) must be increased to their current fair market value to reflect the value of the consideration paid for the acquired business. Thus, if one of the categories of assets of the acquired business is inventory valued on the LIFO method, the carrying value of the LIFO inventory would be increased to its current fair market value for financial reporting purposes and, as a result, the LIFO reserve of the acquired business as of the time of the acquisition would be eliminated for financial reporting purposes.

In contrast, for tax purposes, when one business acquires another business, either through the purchase of the stock of the corporation carrying on the acquired business or through a merger, the historical cost basis of the acquired business's assets (including any LIFO inventory) would be carried over and continued unchanged after the acquisition. This is true not only for LIFO inventory but for all other assets as well. In this circumstance, the LIFO reserve would carry over and be continued after the acquisition for tax purposes. Taking into account the considerable degree of consolidation that has occurred within many industries during the past few decades, it would be expected that the LIFO reserves of businesses that are shown on their balance sheets for financial reporting purposes would be significantly lower than the LIFO reserves that exist for tax purposes.

Discussions with Coalition members suggest that the aggregate LIFO reserves of businesses that use the LIFO method for tax purposes is many times greater than the \$60 billion that Professor Plesko estimates in his testimony.

One other point that Professor Plesko overlooks in his testimony is the devastating adverse economic effect that repeal of the LIFO method for tax purposes would have on businesses that have used LIFO for many years. With continued inflation over several decades, obviously the longer a business has used the LIFO method, the more significant will be the size of the business's LIFO reserve. Among businesses that have used the LIFO method for over 30 years (not an unusual length of time given the high inflation during the mid-1970s when many businesses first began using LIFO), the business's LIFO reserve may have grown to a point where it substantially exceeds the carrying value of the inventory and where the tax that would be imposed on this LIFO reserve could easily exceed the business's entire net worth. This would not be an unusual result, especially in the case of smaller businesses with limited resources that have used the LIFO method for a long time.

3. LIFO as Clearly Reflecting Income

Professor Plesko's testimony devotes only brief attention to the fact that in periods of rising costs, the LIFO method provides a better matching of current costs with current revenues than does the principal alternative, the FIFO method. Moreover, Professor Plesko completely omits any discussion of how, from a tax perspective, the use of the LIFO method helps to ameliorate the harmful effects of inflation on capital investment.

If a business is faced with the situation that, because of inflation, each time that it sells any item from its inventory, it must expend a larger amount of capital than the FIFO cost of the item to simply replace the item of inventory that has been sold, the business would continually be required to increase its capital investment in inventory to simply maintain the status quo. Presumably, this increased capital investment would ordinarily be financed from the proceeds of the sale of the inventory, but if that profit were taxed on a FIFO basis, the after-tax proceeds from the sale of the inventory would in many cases not be sufficient to finance the acquisition of the necessary replacement inventory.

For example, assume that a business normally maintains an inventory level of 10,000 units and the cost of producing those units increases from \$10 to \$11 per unit. If the taxable profit on the sale is determined using the FIFO method, the tax on the sale could in many cases reduce the after-tax profit sales proceeds below the cost of the necessary replacement inventory item, thus necessitating that additional capital be invested in the business merely to maintain inventory at the same level as before the sale. In these circumstances, use of the FIFO method causes the business to pay tax on the unrealized appreciation in the value of its inventories. After all, the business is not in operation to produce inventory, but to sell the inventory and make a profit. Only the use of LIFO can alleviate this problem.

The LIFO method assures that the business will be able to finance the acquisition of the replacement inventory from the after-tax proceeds on the sale of the inventory item to be replaced, and assures that the tax on the sale will not be such that it would require the investment of additional capital in the business merely to maintain the inventory at the same level as before the sale. If the LIFO method were repealed and the FIFO method were required, this would tend to cause businesses to try to increase the selling prices of their goods to the level necessary in order to avoid the adverse results described above, thus further exacerbating inflationary tendencies.

It is a fundamental principle of U.S. tax law that unrealized appreciation in the value of assets is ordinarily not taxed. LIFO is consistent with that fundamental principle, because when the proceeds of sale of an inventory item are reinvested in a corresponding replacement item of inventory, there has been no genuine economic realization event.

LIFO performs somewhat the same function in the tax law that accelerated depreciation performs for capital investment in productive machinery and equipment. The use of LIFO for tax purposes enables businesses to continue in operation during inflationary periods by financing their increasing need for capital to maintain the same physical level of inventory, but at an increasing cost.

In Professor Plesko's oral testimony and in the oral testimony of one of the other speakers at the Senate Finance Committee hearing, the contention was made that inventory should not be singled out for preferential treatment in the tax law by allowing inventory gains to be indexed, whereas gains from the sale of capital investments are not permitted to be indexed. The simple response to this argument is that inventory is not being singled out for special treatment, because the availability of accelerated depreciation on productive equipment and a preferential tax rate on capital gains for individuals perform similar functions, albeit in different ways. In the case of accelerated depreciation, businesses are permitted to recoup their investment in productive plant and equipment more rapidly than would be warranted based on the physical life of the equipment (and more rapidly than for financial reporting purposes) in order to help fund the cost of their eventual replacement. In the case of non-depreciable capital assets, while capital gains are not indexed, capital gains of individuals are taxed at a preferential rate compared with the rate at which the individual would be taxed on other types of income. In this fashion, plant and equipment, inventory and investment in capital assets such as the stock of corporations are each treated by the tax law in somewhat different ways to promote the same overall goal, helping businesses to make productive investments of capital in order to remain in operation and encouraging investors to invest in the stock of incorporated businesses. Professor Plesko seems unwilling to acknowledge this fundamental purpose underlying the allowance of the LIFO method for tax purposes.

4. Potential Abuses under LIFO

Another aspect of Professor Plesko's testimony focuses on his perception of the potential abuses that exist for businesses that use the LIFO method. Professor Plesko's analysis of these perceived abuses again demonstrates his lack of understanding about the rules governing the use of LIFO.

When the potential abuses of LIFO are discussed, the two most frequently mentioned potential abuses both involve artificial decisions concerning inventory levels. In this regard, one potential abuse would be that a business that is experiencing a decrease in inventory levels might be tempted to purchase near year end inventory that it does not need for operations and then resell the unneeded inventory shortly after year end in order to avoid the recapture for tax purposes of the portion of its LIFO reserve that would otherwise result. The other potential abuse is that a business desiring additional earnings for financial reporting purposes might be tempted to artificially reduce its inventory levels in order to recapture inventory layers carried at lower historical costs and report additional profit compared with an otherwise identical business using the FIFO method.

With respect to the first of the above perceived abuses pointed out by Professor Plesko, he is apparently unaware of the significant number of court decisions and IRS rulings that prevent a taxpayer from gaining a tax advantage by purchasing inventory that it does not need for operations in order to avoid a liquidation of low-cost LIFO layers that would otherwise result from reductions in inventory levels. See *United States v. Ingredient Technology Corp.*, 698 F.2d 88 (1983), *cert denied* 462 U.S. 1131 (1983); *Illinois Cereal Mills, Inc. v. Commissioner*, T.C. Memo. 1983-469, *aff'd on other issues* 789 F.2d 123 (7th Cir. 1986), *cert denied* 479 U.S. 995 (1986); *B. A. Ballou & Co. v. United States*, 85-1 USTC ¶ 9290 (Cl. Ct. 1985); Rev. Rul. 79-188, 1979-1 C.B. 191; PLR 7913010.

Apart from the foregoing legal constraints, operational constraints also work strongly against any tendency to carry unnecessary inventory levels, since the constant business practice and pressure in recent years is to maintain inventory quantities at the lowest possible levels in order to minimize the amount of capital invested in inventories.

With respect to the potential abuse from artificially reducing inventory levels to show higher earnings for financial reporting purposes notwithstanding the increased tax liability that might result, the financial accounting community in general and the Securities & Exchange Commission in particular have long required that a company disclose in the footnotes to its financial statements any income generated by liquidating low-cost historical LIFO layers. Thus, the financial community is properly able to discount the effects of such liquidations in evaluating the company's

performance. As a result, there would be no incentive for a company to engage in such a practice, as it would be obvious to the financial community.

As a consequence, the potential abuses that Professor Plesko points out simply do not exist in practice because of operational challenges, as well as long-standing tax and financial reporting safeguards that have been in effect for many years.

5. Book/Tax Conformity

One of the more unusual aspects of the LIFO inventory method is that it is one of the few sections in the Internal Revenue Code where a taxpayer must also use that method in its financial reports in order to be entitled to use the method for tax purposes. Professor Plesko's testimony on this subject again displays a lack of understanding of the history and purpose of this requirement.

Although earlier variations of the LIFO method had existed in practice for a number of years, before 1939, LIFO was not a widely recognized method of inventory valuation. This was no doubt due to the fact that inflation had not been a particular problem for companies, particularly during the Great Depression. However, in 1938 for a limited group of industries, and then in 1939 for all businesses, Congress made the decision to allow businesses to value their inventories on the LIFO method for tax purposes. However, because this inventory method was relatively new at that time, Congress was uncertain whether the method was widely recognized and reached an appropriate result in measuring income. Accordingly, Congress imposed a financial reporting conformity requirement as a condition to the use of the LIFO method for tax purposes. To use a well worn cliché, the requirement forced businesses to "put their money where their mouth was." Thus, in order for a business to be eligible to use the LIFO method for tax purposes, Congress required that a business must also be willing to use the LIFO method in reporting its earnings to shareholders, other types of owners, and creditors of the business.

In light of the fact that the use of the LIFO method during inflationary periods substantially reduces a business's reported profits and that the FIFO method is an acceptable alternative, it is perhaps surprising that so many businesses have been willing to use the LIFO method for financial reporting purposes. Given a choice between alternative methods of inventory valuation, it should not be surprising that apart from tax considerations businesses would for obvious competitive reasons prefer to report their earnings on a method that shows greater amounts of earnings. For this reason, LIFO imposes a significant financial statement penalty on users of LIFO. Notwithstanding the penalty, the LIFO method is completely acceptable under generally accepted accounting principles ("GAAP") and is widely used by companies in the United States.

Professor Plesko's testimony poses the question of how many businesses would use FIFO for financial reporting purposes if the LIFO method were not permitted for tax purposes. He further supports his position by noting that LIFO is not widely recognized as a financial accounting method outside the United States, except in the few countries where it is allowed for tax purposes. That is the wrong question to ask and the wrong comparison to make.

A more appropriate question to ask would be how many businesses would use for financial reporting purposes any of the other provisions in the tax law if the use of such provisions for tax purposes were made contingent on their use for financial reporting purposes. A more appropriate comparison would be to draw an analogy between LIFO and accelerated depreciation. If the use of accelerated depreciation in financial reports were made a precondition to the use of such method for tax purposes, it would be interesting to see whether the financial accounting regulators could be persuaded to allow the use of accelerated depreciation for financial reporting purposes and how many companies would actually be willing to calculate their financial income using accelerated depreciation. Measured against a standard such as this, LIFO seems a remarkably popular and accepted technique.

One final point in Professor Plesko's testimony is his assertion about the views of LIFO from the standpoint of the international accounting community. Professor Plesko asserts that when the acceptability of LIFO as a financial accounting principle was being considered by the International Accounting Standards Committee ("IASC"), no objection to its prohibition in international accounting standards was expressed by the "U.S. delegation" at that time. Professor Plesko's testimony on this subject is based entirely on an article that was published eleven years ago (in 1995), relating to underlying events that occurred in 1991, fifteen years ago. Professor Plesko's assertions regarding the

supposed actions of the “U.S. delegation” are based entirely on assertions in this 1995 article that are attributed in the article solely to “a personal letter to the authors” of the article from the former chairman of the IASC. The composition of the “U.S. delegation” is not revealed, nor is the process by which the unidentified membership of the “U.S. delegation” was determined. In any event, during the past fifteen years since the events recounted in this 1995 article, the LIFO method has continued to be a robust principle under GAAP for U.S. accounting purposes and its use in the United States has not been in any way questioned by the Financial Accounting Standards Board.

In conclusion, I believe that it would be a terrible mistake to repeal the LIFO method for tax purposes.