Inventory valuation and the lifo controversy

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INVENTORY VALUATION AND THE LIFO CONTROVERSY

A THESIS
SUBMITTED TO THE FACULTY OF ATLANTA UNIVERSITY
IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR
THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION

BY
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SCHOOL OF BUSINESS ADMINISTRATION

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CHAPTER I

INTRODUCTION

Statement of the Problem.--In recent years accountants have awakened to the need for a restatement of the principles of inventory valuation. Accountants have hoped that such an investigation would result in the development of more consistent practices in the area of the valuation of inventories.

Because of the effects produced by our changing economic system, business men have turned their attention to the significance of inventory valuation on the reporting of income and subsequently on business policies. Thus business leaders have attempted to secure methods of inventory valuation which would lead to sounder decisions.

An outstanding factor in the pursuit of a more effective method of inventory pricing\(^1\) has been the income tax program. During World War II many firms were faced with the burden of excess profits taxes and sought to be relieved of these taxes which were not on true profits. The result of accountants' desire for better methods of inventory valuation, business men's desire for a method which would alleviate fluctuations in income, and the tax officials' aim of raising more revenue has been a long controversy.

Purpose and Scope.--The purpose of this study is to summa-

\(^1\)The terms "inventory valuation" and "inventory pricing" are used interchangeably throughout this study.
rize what accountants and industrialists have accomplished in their attempt to synchronize inventory valuation with current economic conditions.

Chapter II describes the basic principles and concepts involved in inventory valuation. Chapter III discusses the significance of inventory profits in relation to business policies. Chapter IV gives a detailed discussion of court cases involving the Lifo method and amendments made to the tax laws which have made legal the use of Lifo for income tax purposes. Chapter V attempts to appraise the Lifo method and presents conclusions of this thesis.

Sources and Materials.—Basic accounting texts have been used as background material. Extensive utilization was made of articles published in the Journal of Accountancy and specific books published on the Lifo method—The Retail Inventory Method and Lifo, by Malcolm P. McNaier and Anita C. Hersum and Effects of Taxation: Inventory Accounting and Policies, by J. Keith Butters. Material has also been obtained from government publications and the National Retail Dry Goods Association.

Significance of Study. The major argument for the use of the Lifo method has been the possibility of tax saving by business firms. With continuous emphasis on taxes and pressure on fiscal authorities to lower taxes, Americans have become a tax conscious people. A study relating to changes made as a result of taxation is thus very significant.

A second statement of the importance of a study of inventory
pricing may be borrowed from the American Institute of Accountants:

Perhaps no subject in the field of accounting more clearly illustrates the difference between the problems of a peace-time economy and those of a wartime economy than that of the evaluation of inventories.\(^\text{1}\)

\(^1\text{American Institute of Accountants, Committee on Accounting Procedure, "Valuation of Inventories," Journal of Accountancy, LXXV (January, 1943), 46.}\)
CHAPTER II

THE THEORY OF INVENTORY VALUATION

The term "inventory" has been defined as follows by the American Institute of Accountants:

The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies).1

Inventory valuation is concerned with the pricing of these goods and is essential to a business which is dependent on a stock of goods for its operation.2 In many business enterprises inventory is the most important current asset and its size and balance are essential to the management of the firm.3 For these firms the valuation of inventory may be the most essential factor in determining profits or losses during periods of rising or falling prices. Authorities have come to the conclusion that the valuation of inventories poses more problems than the valuation of any other asset.4

The inventory figure is necessary in the construction of


2Ibid.

3Roy A. Foulke, Our Critical Wealth in Inventories (New York, 1942), p. 28.

the income statement and the balance sheet. It is represented on the balance sheet as a current asset and is reflected in surplus after all claims against assets have been accounted for. It is utilized in the computation of cost of goods sold for the income statement.

Records show that many business failures have been caused by improper handling of inventories. Techniques of inventory control have been developed (1) to keep inventory in a definite relationship with net sales and net working capital, (2) to push conversion of inventory into cash in the shortest possible time, (3) to minimize losses through obsolescence, depreciation and expenses resulting from excessive inventory, and (4) to develop records to give a constant aging of inventory similar to the aging of receivables.1

In formulating inventory pricing policy it is necessary first of all to recognize the overall accounting aim—whether it is to reflect the current condition of the business or the long run condition of the business. Maurice H. Stans has made the following historical note on this question:

In the early history of accounting when the balance sheet was considered the financial statement of principle importance, inventories were dealt with as involving primarily the problem of value in the sense of current worth. The use of the balance sheet by banks and other credit grantors, with an eye to inventory as a support for credit, probably was the most important factor in creating theories of inventory pricing. From this alone and seemingly without adequate definition of terms there evolved the formula under which inventories were said to be stated at "cost or market whichever lower." In the application of this rule, however, the terms "cost" and "market" were variously used and inconsistently employed and the result was and is a great diversity of practice.

1Roy A. Foulke, op. cit., p. 37.
In searching for a sound basic concept to which to relate a statement of principles dealing with inventory pricing, it is necessary to recognize the shift that has since occurred in the emphasis from the balance sheet to the income statement as containing the more significant financial data. This shift leaves suspended in the air, and without conceptual foundation, many of the earlier and still existing inventory practices and discredits conservatism per se as a factor. Undue conservatism is no longer a virtue in inventory pricing for the reason that understatement of value at one date results in overstatement of income in a subsequent period.¹

A look at corporate activity reinforces the trend of the change in accounting aims as it relates to our current level of economic activity. In our day a great deal of business is done by corporations which are continuously growing. Thus, there are problems of balance sheet valuation which are entirely different from those of an industrial system where the net worth method would be adequate for determining periodic income. The basic concept of corporate responsibility to stockholders alone calls for an income as nearly correct as possible and on as current a basis as possible.²

The following account shows that the basic objective of inventory valuation is the determination of income and that the primary basis of valuation is cost.

It is now generally understood that accounting is not essentially a process of valuation but the allocation of historical costs and revenues to the current and succeeding fiscal period. Recognition of this concept, which paralleled the shift in emphasis to the income statement, likewise offers the basic tenet for dealing with the subject of inventory pricing.

¹Maurice H. Stans, "Inventory Pricing," Journal of Accountancy, LXXII (February, 1946), 100.

The amount at which inventory is stated at any given date is not primarily a recognition of value, but is intended to measure the portion of the stream of costs incurred in acquiring and producing goods which can reasonably be applied to revenues of the future with profit making effect. It is a deliberate step in the matching of costs against revenues.

This leads to a conclusion that the primary basis of stating inventories is cost, but only in the sense and to the extent that such cost is deemed to be properly allocable against revenues of ensuing periods.1

While cost is the primary basis for valuing inventories, accountants have long recognized that actual cost is not adequate. The actual cost basis excludes the effect of changing market conditions from the computation of net income.2 It has been found that there is a need for modification of procedure in the following instances:

1. When there is a change in the price of goods.
2. When there is a loss in value of merchandise as a result of using merchandise for display.
3. When seasonal goods are on hand at the end of the season.
4. When it is necessary to write down damaged goods.3

The solution to the problem of inadequacy of the cost method in valuation has been the adoption of the method known as "cost or market whichever lower" or "lower of cost or market." The major problem is to report only cost which is applicable to revenues of future periods. This cost has been defined as "use-

1Maurice H. Stans, op. cit., p. 100.
3Ibid.
ful cost "or "recoverable cost." Useful cost is that which is likely to be recovered and which can be expected to produce a normal profit. The foregoing concept supplies the basis for theoretical acceptance of the rule of cost or market whichever lower. This method takes care of declines in the value of goods on hand.¹

The position taken on the concept of useful or recoverable cost is substantiated as follows:

When market is lower than cost it is indicative of the portion of cost beneficial to subsequent periods and income determination requires that the difference be taken up as a current loss. The ability to be disposed of at a profit constitutes the usefulness of an inventory commodity and when, because of deterioration or other circumstances, the amount possible of being realized will not provide a profit, the usefulness of the whole cost has partially expired and should be accounted for.²

To comprehend fully the rule of cost or market, whichever lower, it is necessary to know the meaning of the terms "cost" and "market" applicable in this case. The term "cost" as used in inventory pricing has been defined by most accountants by enumerating the factors included in cost.

Carman G. Blough gives the following brief definition of cost:

As applied to inventories, cost means in principle the sum of applicable expenditures and charges directly or indirectly incurred in bringing an article to its


²Ibid.
existing condition or location.¹

Regulations 118 of the Bureau of Internal Revenue defines the cost of merchandise produced as (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) indirect expenses incident to and necessary for the production of the particular article, including such indirect expenses as a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.²

In practice, different industries include different factors in cost. In regard to burden costs it has been recommended that at least all normal burden costs be included. However, there is the dilemma of defining what normal burden is. Thus, accountants have recognized the difficulty of determining what costs are inventoryable and concede that in many instances theory conflicts with practice and has to be recognized as unattainable perfection.³

The term "market" as used in the phrase "cost or market" has been defined by Mauriello as "the current replacement cost of goods whether through replacement or reproduction."⁴ Mauriello


²Joseph A. Mauriello, op. cit., p. 9.203.

³Maurice H. Stans, op. cit., p. 102.

gives the following exceptions to this definition:

1. Market should not exceed the net realizable value (selling price minus predictable cost of completion and disposal).

2. Market should not be less than net realizable value reduced by an allowance for an approximately normal profit margin. Inventory should be written down from cost to level of cash realizable value.¹

Authorities have held different opinions on the meaning of the term "market." Some advocate that it refers exclusively to the current replacement or reproduction price. The English define market as being the realizable value after allowing for expenditures before sale, with apparently no allowance for profit. Americans calculate realization value after allowance for profit. Other authorities define market as the lower of replacement cost or realizable value.²

Market price for raw materials and supplies is determined by current price quotations. In the case of work in process and finished goods of a manufacturer, market is defined as the cost to reproduce, using current price for raw materials and current labor and overhead.³

The lower of cost or market rule has been the most widely used basis for inventory valuation. However, other variations of cost have been used in valuing inventories—cost or less

¹Joseph A. Mauriello, op. cit., p. 9206.
²Maurice H. Stans, op. cit., p. 103.
³Ibid.
than cost, cost or less than cost not in excess of market, market value, and assigned value. The lower of cost or market rule was not used in this country until the introduction of the Federal income tax program in 1913.¹

Either of two procedures is used in applying the cost or market rule. The procedure used would depend on the nature of the products and the degree to which prices of the commodities fluctuate. For companies with one major product, it is recommended that the lower of cost or market figure be taken for the aggregate figures. For companies with a variety of products, the prevailing practice is to take the lower figure for individual items in the inventory. In the latter case if the prices fluctuate consistently for all items in the inventory, it may be wise to use the aggregate method.²

The value used has a significant effect on the net profit reported for the current period and on the inventory as shown on the balance sheet which in turn affects profits for the following period.³ Accountants have stressed the use of the item-by-item method because of the effect of picking up losses without a reduction of gains.⁴

After establishing the basis for valuation, the next step in inventory pricing is the adoption of a method of determining

¹Roy A. Foulke, op. cit., p. 28.

²Committee on Accounting Procedure, American Institute of Accountants, op. cit., p. 199.

³Roy A. Foulke, op. cit., p. 28.

the flow of goods. It has been recognized by some accountants that the assumption of the flow of goods per se is not of much significance. In determining an appropriate method, a more relevant conclusion may be obtained by considering the methods as assumptions of the flow of costs, not related to the flow of goods.¹

In the early stages of industry, it was possible to price goods at costs shown by specific invoices. Goods were more easily identified and the matching of physical identity with price was a simple process. With the growing complexity of industry, it became more difficult to match the physical identity of goods with prices. Thus, it became necessary to make arbitrary assumptions as to the flow of costs. The first-in first-out premise and the average cost concept were introduced. The last-in first-out procedure was later adopted to recognize the economic relationship of sales prices and costs in cases where there is a high correlation between sales and cost prices.²

Because of extensive development of production processes, other techniques have evolved for determination of the flow of costs in industries. The retail inventory method will be of importance to this study. The retail method "takes as its initial starting point the retail, or selling price value of

¹Carman G. Blough, op. cit., p. 205.

²Maurice H. Stans, op. cit., p. 98.
merchandise rather than its cost price, under which the physical inventory itself is actually counted only at selling price and not at cost, and which finally arrives at a cost valuation entirely on the basis of average relationships of retail and cost figures over the period. The retail method, as its name suggests, is used by the retail trades industry. In the early years of its use, the FIFO assumption on a cost-or-market basis has been applied. In recent years the LIFO method has been applied to the retailing principle. The retailers' influence in obtaining the use of LIFO will be dealt with in Chapter IV.

The major assumptions of the flow of costs may be described in the following manners:

1. The average cost method may be termed the "pool" concept--all factors going into one end of a great operating vat, coming out of the other end in the form of the completed product. Each inventory figure is an average of available cost factors.

2. The first-in first-out method assumes that cost elements move along in chronological sequence.

3. The last-in first-out method may be termed the "by-pass" concept. All cost factors incurred are interpreted as first being used to build up the inventory. After the inventory is built up all additions to stock are treated as by-passing the inventory accumulation and becoming immediately assignable to revenues.

The method of inventory pricing utilized depends on the industrial structure. The average cost concept has been advocated

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for use by industries which carry goods subject to frequent changes in style, etc. and in industries with rapid turnover of inventory and where inventory is a major factor in determining profits or in the composition of current assets. The average cost method smooths out fluctuations in prices through its weighted moving average. Thus, it is more satisfactory from a managerial viewpoint in cases where average costs are more important than costs of a particular lot. The average cost method has not been allowed by the Bureau of Internal Revenue for use in reporting income for tax purposes. However, certain industries have found it useful for other purposes within the firm.

Fifo has been advocated for use in industries with characteristics similar to those for which the average cost method is applicable. The Fifo method, utilizing the cost or market rule, has been referred to as the "traditional method" throughout accounting literature. It was the first assumption developed as to the flow of costs. In terms of accounting objectives, whether the short run current view of the business or the long run view of business, Fifo achieves the former objective. It meets the requirements of the balance sheet point of view more nearly than any other method.

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1Maurice E. Peloubet, op. cit., pp. 70-74.

2J. Keith Butters, Effects of Taxation--Inventory Accounting and Policies (Boston, 1949), p. 3.
Lifo has been recommended for use in enterprises in which current material prices are reflected in sales and where it is necessary to carry a large inventory of basic materials with a slow turnover—two, three or four times a year. Many accountants believe that the Lifo method approximates the matching of current costs with current revenues more nearly than any other method. 1 "Fundamentally, the significance of Lifo may be summed up in the observation that it represents a method of recording additions to and withdrawals from inventories in such a way as to minimize the effect on operating profits of adventitious price fluctuations that distort the actual course of a firm's operative efficiency." 2 It reflects a conception of the proper aim of business record-keeping—to present "a moving picture" of its operation instead of periodic "snapshots" of its position. 3

"Adventitious price fluctuations," referred to above, result in what has been termed "inventory profits and losses." Discussion is now turned to this concept of profits.

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1 Maurice E. Peloubet, *op. cit.*, p. 75.
2 Ibid.
CHAPTER III

INVENTORY PROFITS

A business which relies heavily on inventory for its operation must carry a sufficient amount of commodities to meet demand. Thus, a firm would have a minimum quantity which it would consider adequate to insure continuity of operation. Because of these actual practices, accountants have come to consider inventory as a constant volume of goods to which units are added by purchases and/or manufacture and subtracted by sales.¹

Inventory profits have been defined as the increment in value assigned to a constant physical inventory because of the increase in cost of newly acquired inventory units.² This temporary increase in value has also been referred to as paper profits.

The use of the Fifo method of accounting results in the appearance of inventory profits during periods of heavy economic fluctuations. Accountants have found that Fifo on a cost-or-market basis causes a firm to report profits far out of line with what it has actually earned. In a period of rising prices the following developments will occur when using Fifo. All goods acquired in a period will not be sold in that period;


²J. Keith Butters, op. cit., p. 3.
some will be carried over to the next period and valued at the increased prices of the latter. Thus, goods on hand at the beginning of the period will be valued at higher prices at the end of the period. The increased price on inventory is reported in the balance sheet and results in a higher profits figure. The amount above what is real profit for that period is inventory profit.

In a period of falling prices opposite conditions would exist. Goods which were purchased at a higher price at the beginning of the period will be valued at a lower price at the end of the period. Because of a lower valuation of goods previously valued higher, the result is inventory depreciation or loss.

Such increases or decreases in profits are unrealized gains or losses because they do not represent disposable cash. The investment is tied up in this fixed quantity of inventory which will not be sold unless the firm intends to terminate operations.\(^1\)

It has been shown by research groups that inventory profits and losses are very large during periods of price fluctuations. The Department of Commerce has compiled data on estimates of corporate profits of certain firms. In its computations the Department of Commerce utilized an inventory valuation adjustment figure which gives an estimate of inventory profits and losses included in the profits figure. The results indicate

\(^1\)J. Keith Butters, *op. cit.*, pp. 2-4.
that before the application of the adjustment figure, profits were very high during periods of prosperity and very low during a decline in economic activity. The inventory valuation adjustment brought profits in line with realizable gains and losses.¹

Statistics of Income data also shed light on the size of inventory profits. Attempt has been made to show the relationship of inventories to an appropriate measure of the size of industry. The measures employed were ratio of inventory to net worth and to total assets. It was found that for industries in which those ratios are high, inventory profits and losses have significance. The influence of price changes would determine the extent to which these profits or losses would actually occur. Inventory profits or losses are large in relation to net worth in such industries as apparel, leather and trade corporations.²

Paper profits have more significance for industries with large inventories relative to other assets, relatively low sales markups, and wide price fluctuations. The meat packing industry has been cited as typical in regard to these characteristics.³ Other industries are the large mail order organizations, chain stores, nonferrous metals, and metal processing. For all of these industries inventory is subject to rather

²Ibid., p. 22.
³Ibid., p. 25.
violent price fluctuations.¹

These price fluctuations accentuate the unending economic problem—the business cycle. Following an appreciable price change, the Fifo method of reporting inventory would lead to two significant effects—cash and psychological. During a period of rising prices profits would be reported at an increased value because of inventory appreciation. Because of the increased profit reported, more demands would be made on the business than otherwise and the business man will be more favorable toward expenditures. His taxes increase, dividends are declared, and decisions may be made to increase wages or expand the plant. Because these additional profits do not represent cash, the firm is faced with a shortage of cash. It follows that the effect of Fifo on the cash position is to increase demands for payments which are not proportionate with cash available. During a period of falling prices, there are less demands for cash payments and the business is in a better cash position.²

To management, stockholders, labor leaders, and the general public, profits reported in financial statements are viewed as actual expendable profits. When higher profits have been recorded and the business is faced with new demands and a short cash posi-

²J. Keith Butters, op. cit., p. 105.
tion, borrowed funds must be used. The banker is also misled by the high working capital position of the business and funds are easily obtained. Prices begin to rise with the granting of loans and increased consumer demand.\(^1\)

The price spiral continues until the peak is reached and then begins to taper off. Profits recorded as a result of price increases also begin to taper off. Businesses begin to decrease expenditures and prices begin to fall, followed by declines in inventory values and the disappearance of inventory profits. The obligations which the business obtained as a result of overoptimism remain to be paid for out of its real earnings.\(^2\)

The reverse situation is true for a period of falling prices. With an apparent reduction in profits because of a decline in prices, undue pessimism follows. Much useful business activity will be curtailed—dividends withheld, loans refused, wage increases withheld, and expansion postponed.\(^3\)

In the course of a typical business cycle, business in general has its smallest inventories during the early recovery phase when goods are cheap. Inventories begin to rise as business improves and the peak is reached during the period of general price collapse. At this time, a few firms may be able to sell out, but the other firms must hold the large inventories

\(^1\)H. B. Arthur, \textit{op. cit.}, p. 10.
\(^2\)Ibid.
\(^3\)Ibid.
of goods and take the losses on them. Businesses which engage in hedging may cope with the problem by matching inventory gains and losses against hedging gains and losses.\(^1\)

If business has piled up inventory on a rising market, the price increases may end before the cost spiral. Inventory appreciation ceases to contribute its increment to profits and retrenchment begins before prices actually decline. The overall effect is inventory losses if prices have not fallen below replacement costs. Such losses may seem real to many business men.\(^2\)

Some economists have applied the concept of inventory profits in attempts to explain the business cycle. In terms of overinvestment theory, it is believed that inventory profits contribute to overinvestment in times of recovery and under-investment in periods of recession. Applied to the underconsumption theory, inventory profits exaggerate the belief that consumption is below par in certain periods. The concept of paper profits may also be applied to other business cycle theories.\(^3\)

From the above it is seen that unwise business decisions may be made on the basis of income reported on the Fifo basis.

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\(^1\)H. B. Arthur, *op. cit.*, p. 11.


\(^3\)Ibid., p. 39.
Such decisions may be detrimental to the firm and the economy. The traditional method was suitable for a period of stable prices, but our economy is far from price stability. Accountants began to realize before 1925 the need for a device to appropriately state income during periods of fluctuating prices.¹

Over a long period of time inventory profits and losses are averaged out and real profits are shown regardless of the method of evaluation. Our economic system requires operating statements for short periods, and our accounting must be geared to reporting income for the short fiscal period. Thus, there is a need to smooth out fluctuations in income long before the real status of profit can be shown.

**Methods of Reducing Inventory Profits**

Good accounting practice through the years has made use of reserves to serve as cushions in event of emergencies arising in the course of business operations. However, there was a lag in acceptance of this principle in inventory valuation.²

The establishment of a reserve to absorb fluctuations in inventory values has been described by the base stock principle which is utilized in the base or normal stock method, Lifo and the inventory reserve method.


Through use of these methods of inventory valuation attempt is made to accumulate actual earnings of gross revenue without regard to the period in which the revenue and costs are realized in terms of actual cash. It is a logical application of the accrual system of accounting.¹

The base stock method was used in Scotland, Wales, England and Holland for more than a half century before use in the United States. The American Smelting and Refining Company was the first large corporation in the United States to employ this method in 1903; the National Lead Company adopted it in 1913; the American Can Company in 1917; and the Endicott-Johnson Corporation in 1936.² The method was utilized for internal reporting, especially for reports to stockholders.³

Under the base stock procedure, it is assumed that inventory is a fixed asset and that the pricing of it should be on the basis of a fixed asset. The amount of goods necessary to meet production needs are valued at long run “normal” cost and all goods over the required basic stock are priced at current cost on the traditional basis.⁴

²Roy A. Foulke, op. cit., p. 32.
³Ross G. Walker, op. cit., p. 76.
The goods over the required basic stock have been referred to as marginal inventories and the base goods, reservoir inventories.¹ The normal stock of goods is considered a permanent investment as equipment, which is priced on the basis of its purchase price. Even though the physical inventory is constantly changing, it is assumed that the amount invested is unchanged unless the goods on hand are increased.²

There may be a decline in physical quantity of the base stock because of changes in demand, shortages of supply or other conditions. When this occurs, goods which were sold from the base stock are charged to cost of sales at their current market value and the excess of that value over fixed cost is recorded in an account known as the "replacement reserve" account. When the base stock inventory is brought back to its level, goods used for this purpose are charged into inventories at fixed cost. If the purchase cost exceeds fixed cost, the excess is charged against the replacement reserve. The balance in the reserve, which is usually minimal, is charged to profit and loss as an extraordinary cost adjustment.³

Another problem is encountered if the market value falls below the valuation of the base inventory. In event of this, the base stock is carried at this lower level or until another

¹J. Keith Butters, op. cit., p. 242.
³J. Keith Butters, op. cit., p. 243.
Lifo is similar to the base stock method. Indirectly, a basic inventory is left on the books at original prices. The last-in goods are sold and replaced and the original stock remains on the books. The Lifo and base stock methods differ in their distinction between reservoir and marginal inventories. A firm using base stock chooses a quantity level for the reservoir and maintains that level on a rather permanent basis. The base inventories are set at such a low level that sizable marginal inventories are carried. Lifo considers the base inventories as being included in both beginning and ending inventories. A fixed valuation is placed on these inventories which leads to the exclusion of inventory profits and losses from income. The base inventory for Lifo varies from year to year as inventories are expanded or contracted. Thus Lifo more effectively smooths fluctuations in income due to price changes than base stock.

If the reservoir is reduced below its fixed level, the base stock method charges the goods against income at their current values rather than at normal stock values. Lifo charges liquidated base inventories at fixed value. The base stock method

1Roy A. Foulke, op. cit., p. 32.
3J. Keith Butters, op. cit., p. 246.
4Ibid.
is thus more adequate for reporting to stockholders. For the
determination of taxable income, the base stock method would
be disadvantageous because it permanently excludes gains or
losses realized on the liquidation of reservoir inventories
from income. Under Lifo such gains and losses are excluded
only temporarily, which is consistent with the American con-
cept of taxable income.1

The use of base stock income tax reporting poses a further
problem for tax officials because of the freedom allowed manage-
ment in setting the level of the reservoir. There would be the
need for a regulation to require that the base stock inventories
be kept in line with the current scale of operations in order
that the base stock method will match current costs with cur-
rent revenues at the desired level.2

The inventory reserve method designates a portion of in-
come equivalent to an increase in cost of a reasonable basic
inventory during a period of rising prices. During a decline
in market prices, an amount of the reserve is returned to in-
come in proportion to the decline in price. The inventory is
valued at cost without consideration for market unless the price
falls below the point at which the initial inventory reserve
is made.3

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2Ibid., p. 247.

Inventory reserves have been employed for so many purposes that there has been necessity for clarification of use as a method of inventory valuation. The procedure was clarified by the American Institute of Accountants in Research Bulletin No. 31 issued in 1947. The Bulletin defined reserves in terms of two categories—(1) reserves designated out of current inventories or purchases contracted for and (2) reserves for obsolescence, deterioration or similar losses, or for reducing inventory to Lifo or its equivalent. The American Institute of Accountants holds that reserves in the first category should not enter into the determination of net income. The latter category constitutes an acceptable deduction in the determination of net income.1

The Institute has stated the following requirements for the use of inventory reserves:

1. The reserve should be created from surplus.

2. The reserve should not be used to absorb costs or losses and no portion should affect determination of net income for the year.

3. The reserve should be returned to surplus when no longer necessary.2

The inventory reserve method prices inventories at a figure close to the Lifo valuation.3

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1J. Keith Butters, op. cit., p. 249.

2Ibid.

3Ibid., p. 251.
The inventory reserve method may be disadvantageous because it places estimated inventory profits into a reserve account rather than in profit and loss. For firms which use financial statements as guides in making policy, the reserves may represent profits to them.\(^1\) The inventory reserve method has been used for reporting to stockholders and has not been allowed for tax purposes.

The essential points of the base stock family are (1) that profits are based on replacement costs and (2) fluctuations in the price of basic inventory are not allowed to affect earnings, and reports furnish a better guide for intelligent business management. Of the three methods, the base stock and Lifo methods are the most desirable because they eliminate inventory profits from the operating statement and the balance sheet. These two methods value the basic inventory investment at a constant price and charge current raw material costs against current sales.\(^2\)

The Lifo method has been widely advocated to counter the undesirable cyclical effects of the use of Fifo. In the discussion which follows, the history of the base stock principle in relation to its fight in the Courts is given.


\(^2\)Ibid.
CHAPTER IV

THE LIFO CONTROVERSY

Methods of valuing inventories have been influenced to a great extent by federal laws since the enactment of the federal income tax law in 1913. Though several methods may be employed in pricing the various categories of goods in a firm's inventory, more expediency is achieved through use of the minimum. Many firms have adopted for as extensive use as possible inventory pricing methods approved by the Bureau of Internal Revenue.

In deciding which methods are to be used for reporting taxable income, the government has been slow to accept recognized principles of accounting. At the time that the 1909 Corporation Excise Tax Law was passed, the cash basis of accounting was practically replaced by the accrual basis. Yet the law required the cash basis for income reporting, which excluded the use of inventories. However, the Commissioner's regulations of that period did mention inventories. The early regulations required the cost basis of reporting inventories. As early as 1917, the Treasury allowed cost or market, whichever lower. The Bureau of Internal Revenue slowly conformed to established accounting methods. The accrual basis of accounting was recognized in the Revenue Act of 1916.¹

The question of the use of the base stock method was raised

during proceedings for the Revenue Acts of 1917 and 1918. The Advisory Tax Board of the Treasury set the precedent for barring the base stock principle in its 1917 recommendation. The Board held that the base stock method was not acceptable because very few firms used base stock, and it could not be considered in accord with best accounting practice. It stated further that if the use of base stock were permitted, there would be unfair discrimination in favor of those who used it.\(^1\) Thus progressive business men were forced to accept a standard which the majority complacently held to. Besides, the Board was not accurate in its opinion that only a few companies used base stock. Records show that a substantial number of large companies were using the method for corporate purposes.\(^2\) As for discrimination in allowing its use, it seems that there was no basis for this argument on the part of the government, for the new method could be made available to all desiring its benefits.

The Treasury based its decision on the use of an annual accounting period. Each sale for a period constituted realization of income or loss for that period. Thus, any system which failed to report all such transactions as income for that period could not most clearly reflect income. The Treasury was of the opinion that increased costs of inventories were

\(^1\) "Base Stock Inventories and Federal Income Taxation," \textit{op. cit.}, p. 1435.

\(^2\) \textit{Ibid.}, p. 1437
not unrealized appreciation, but reinvested realized income. Thus base stock was fundamentally unsound because it overstated profits in periods of declining prices and understated them in periods of rising prices. Base stock was merely a device for stabilizing profits and providing reserves out of income for future contingencies.¹ The Treasury was overlooking a very sound accounting practice. In support of Fifo, the Treasury stated that "since the first-in first-out presumption was supported by the balance of probabilities, it must be the only system which clearly reflects income."²

The Revenue Act of 1918 set the basis for control of inventory reporting methods by the Bureau of Internal Revenue. The Act is stated as follows:

Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

The Advisory Tax Board culminated its opinion on base stock in Recommendation 65, issued in 1919. The ruling stated that:

...Neither the base stock method of taking inventories, nor the moving average method, nor a method based upon the presumptions that goods in the inventory are the earliest purchases, is in conformity with the Revenue Act of 1917 or the Revenue Act of 1918 and recommends that

¹Base Stock Inventories and Federal Income Taxation, op. cit., p. 1436.

²Ibid.

no changes be made in the present regulations with respect to the method of taking inventories.\(^1\)

The tobacco companies were able to gain some relief from this provision around 1920. They appealed to secure use of the average method and were granted permission on the grounds that for their purposes there was no method more nearly approaching theoretical accuracy which was practically possible.\(^2\)

The following conditions were among those cited by the tobacco industry which would necessitate use of the average or a similar method:

1. The need for purchasing in small lots of varying quantities and quality at widely fluctuating prices.

2. The long period of time in which raw material must be held.

3. The oldest purchases are not and cannot be used first because of the necessity for blending.\(^3\)

By use of the average method, the tobacco companies were able to obtain an intermediate effect between Lifo and Fifo. Thus, they would reduce inventory profits which might occur.

**Kansas Structural Steel Case**

A significant case in the early history of base stock is that of the Kansas Structural Steel Company.\(^4\) The case was

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\(^1\)Frederic W. Kilduff, *op. cit.*, p. 292.

\(^2\)Ibid., p. 293.

\(^3\)Ibid.

tried in the Court of Tax Appeals in favor of the company; reversed by the U. S. Court of Appeals in favor of the Tax Court and was finally appealed to the United States Supreme Court.

The company was engaged in fabrication and erection of steel plates for buildings, bridges and tanks. Since 1916, the company had designated 5,554 tons of material as base stock and valued the material continuously at 1916 prices. All materials above the minimum stock were carried at market prices. Kansas contended (1) that it was necessary to keep materials on hand for emergency purposes and (2) that these materials contributed nothing to income and that taxes should not be assessed on their valuation. By revaluing the 5,554 tons at current prices, the Commissioner increased the 1918 inventory by $168,849.46 and the 1920 inventory by $171,131.61. The taxes was increased $7,656.74 for 1918 and $15,953.36 for 1920.

The decision of the Supreme Court was in favor of the Tax Court. The government said that the valuing of a fixed quantity at a constant price from year to year offsets inventory gains of one year against losses of another, which is not permissible in reporting taxable income. Here, the government sustained the Tax Board Recommendation of 1919 which holds that the requirements of the federal income tax system are based upon an annual accounting period which requires that gains or losses be accounted for in the year in which realized.
In reference to the taxation of a reserve supply of material, the Supreme Court made the following statement:

A reserve supply of material maintained by a corporation engaged in the fabrication and erection of steel plates for buildings, bridges, tanks, etc., which does not carry finished production stock, but fabricates the plates for specific structure or contracts, is an income producing factor within the requirement of the Internal Revenue Bureau...that inventories at the beginning of each year are necessary in every case in which the production or sale of merchandise is an income-producing factor, notwithstanding, it is replaced in kind from materials ordered from the mills for each structure or contract. ¹

The major argument voiced by the government was that of failure of the Kansas Structural Steel Company to comply with the annual accounting system. They did not discount the desirability of the use of the base stock method for valuing inventories.

The government believed that the keeping of material within certain limits is not of significance and stated that the inventory was not to be regarded as permanent stock. Moreover, the company had not designated a standby stock and had given no reasons for excepting the 5,554 tons from market price. The government stated further that to draw a line at this point distorts the computation of income in accounting periods.

With this decision in 1929, the government was still adamant in its position on the base stock principle. It failed to recognize the necessity and actual practice of maintaining

¹Lucas v. Kansas City Structural Steel Co., op. cit., p. 848.
a minimum inventory for continuous operation of a business. It was unaware that the inventory was considered equivalent to a fixed asset in a going concern. Least of all the government had no substantial knowledge of the advantages of base stock. However, the burden of proof lay with the company which did not adequately support its position. Finally, the government succeeded in holding to the traditional method of valuing inventories.

The Revenue Acts of 1938 and 1939

As late as 1936, the tax officials' ruling on the pricing of inventories based on the 1918 Act remained unchanged. During hearings before the Senate Finance Committee for the Revenue Act of 1936, industrial associations and accountants presented briefs urging the adoption of Lifo. However, some progress was made at this time because wheat and cotton processors were permitted to use hedging in eliminating gains or losses on raw materials in inventories. This relief made possible by the General Counsel formed the basis for the significant legislation of 1938.

Following is the General Counsel's statement:

Such hedges...are generally regarded as a form of insurance (the only kind available as protection against such risk) necessary to conservative business operations.... Differences in accounting methods do not affect the principle though they vary its application.... Inventories involving adjustments to market at most permit adjustments in taxable income to take into account realizable rather than realized gains or losses and require corresponding changes in the basis for computing gains or loss.... Where insurance eliminates the risks...obviously either
the goods involved must be eliminated from such inventories or the distorted results attained in net income by including such goods in inventories must be corrected in some way. As the elimination of spot goods protected by hedges from inventory presents substantial practical difficulties, it seems preferable in the ordinary case to allow such cotton to remain in the inventory and to eliminate the resulting distortion in net income by correcting offsetting adjustments thereto.¹

The General Counsel's statement recognizes the need for relieving the firm of inventory profits and losses. In contrast to the Kansas Structural Steel decision, acceptance is given the maintenance of a minimum inventory, the pricing of which will not be allowed to distort income. Further, the General Counsel is of the opinion that different accounting methods may be fitted to a principle without distorting the principle.

The General Counsel's memorandum was relied on heavily in arguments presented to the Senate Finance Committee for Hearings on the Revenue Act of 1938. Unlike the weak position of the Steel Company in 1929, the Lifo forces in 1938 came together with very strong arguments for its support. The American Institute of Accountants made recommendations for the amendments to the Revenue Act and filed a brief in support of Lifo. Briefs and statements were presented by the following before the Senate Committee on Finance: Maurice E. Peloubet, member of firm of Pogson, Peloubet & Co., Certified Public Accountants

of New York City, representing Copper and Brass Mill Products Association; I. R. Glass, Tanners Council of America; and D. A. Callahan, American Mining Congress.\textsuperscript{1}

The Committee on Taxation of the American Institute of Accountants is frequently called upon to submit recommendations to the Treasury Department for revision of revenue laws. In its recommendations to the Senate Committee, the Committee on Taxation stated that industries other than cotton and wheat should be allowed to apply current costs to current sales under the "replacement" or "last-in," "first-out" inventory method. The following industries were cited as those for which Lifo is most adaptable:

1. Those in which operating processes are continuous.
2. Those in which the period of processing is relatively long.
3. Those in which minimum inventories must be maintained constantly.
4. Those in which raw materials represent a major part of the total cost of products.

The A. I. A. stated further that the methods recommended are substantially accepted in industry, endorsed by accounting authorities, and recognized as appropriate by the Securities and Exchange Commission.\textsuperscript{2}

\textsuperscript{1}U. S. Senate, 75th Congress, 3rd Session, Revenue Act of 1938, Hearings Before the Committee on Finance on H. R. 9682, (Washington, 1938).

The A. I. A. countered the 1918 Act in its statement that the normal stock and Lifo or replacement methods clearly fall within approved standard methods of accounting and are best suited to the needs of certain businesses.

The Copper and Brass Mill Products Association

The Copper and Brass Mill Products Association included manufacturers of copper and brass sheets, tubes, rods and other shapes, principally for further fabrication by other manufacturers and to some extent for use as finished products.

In his argument for the Copper and Brass Mill Products Association, Mr. Peloubet asserted that the Association members were subject to discrimination by the U. S. Treasury Department. Other industries were permitted to use recognized accounting methods to determine taxable income and are taxed on income which is realizable while the Copper and Brass Mill Products industry was taxed on unrealizable income determined by the Fifo method, which was not recognized by the industry. This industry had no organized futures market as was available for cotton. In reference to the consideration given the cotton textile and flour industries, Mr. Peloubet stated that "the entirely fortuitous circumstances of the existence or absence of an effective futures market is thus made basis of discrimination between various taxpayers similarly situated."


2Ibid., p. 146.
The copper and brass mill products industry reported that it matches purchases and sales so as to avoid losses and thereby preclude gain from market fluctuations. The practice of the metal fabricator is contrary to the Fifo requirement of applying current sales against earliest purchases which results in a statement of income which includes profits and losses not produced by actual transactions. Mr. Feloubet reported that the use of Fifo greatly distorted income in the copper and brass mill products industry because of the nature of manufacturing operations, relatively high cost of metals they use, and fluctuations in the prices of those materials. Changes in prices have a maximum effect because of the long period of time involved in the manufacturing process.

The argument stated that Lifo corresponds with the mill's actual practice in conducting their business and is used for their corporate accounts, though it is not allowed for tax purposes.

Mr. Feloubet had appeared before the Senate Finance Committee at hearings on the Revenue Act of 1936 to request legislation which would permit use of Lifo and was informed that it was within the power of the Commissioner of Internal Revenue to permit the use of Lifo and that legislation was not required. The Brass Mill Products Association had been advised that appropriate action could be obtained from the Treasury Department; however, the Treasury continued to require use of methods of determining income not generally considered correct for the copper and brass
mill products industry. The Association was in a dilemma, for from past experience no relief could be obtained from the Commissioner.

The Association did not expect a reduction in taxes over the long run, for income would be the same over the cycle regardless of the method, and the taxes would therefore be the same. The main object of the industry was that it did not want to pay taxes two or three years before profits are made just because inventories are written up which cannot be sold. The Association presented data which showed that by use of Lifo, profits would be reported at approximately the same level under stable, rising, and falling prices. Along with his brief, Mr. Peloubet presented opinions of leading accountants, opinions of accounting authorities, resolutions approving Lifo made by the Committee on Federal Taxation of the New York State Society of Certified Public Accountants, data on Lifo and similar methods, list of corporations using Lifo, bibliography on Lifo and similar methods, and a list of trade associations approving Lifo and similar methods.

Mr. Peloubet recommended that the following wording be added to Regulations 22(c) of the Internal Revenue Code:

Goods remaining in inventory which have been so intermingled that they cannot be identified with specific invoices may be deemed to be the goods first purchased or produced during the period in which the quantity of goods in the inventory has been acquired and the cost of goods most recently sold may be deemed to be the cost of those most recently purchased or produced, if in conformity with the taxpayer's method of keeping his books or records and with the best accounting practice in the trade or business.¹

¹U. S. Senate, Revenue Act of 1938, op. cit., p. 146.
Tanners Council of America

I. R. Glass of the Tanners Council of America presented an argument similar to that of the Brass Mill Products Association. Mr. Glass stated that for the tanning industry the only criterion of true income is determined by applying latest or replacement costs to current sales. The tanners buy hides and sell leather on a day by day market, and are in business to obtain a converting profit. It is therefore necessary to employ replacement prices which represent the tanners' latest or replacement costs and are the only adequate measures of realized or realizable income.

American Mining Congress

D. A. Callahan represented the American Mining Congress, which included the entire industry from producer to fabricator of metal products. Mr. Callahan stated that the present method allowed for inventory reporting purposes included an element of speculation in the computation of taxable income because fluctuations in market prices are reflected as profit or loss on each sale of refined metals.

In support of his recommendation for the mining industry, Mr. Callahan made the following statement:

The method of matching current sales against current purchases has desirable results for both the producer and the processor. It assures the processor of his operating profit or toll and enables him to pay the producer upon delivery of his metal to the smelter. It also assures the

2Ibid., pp. 484-486.
producer of a market free from the speculative element which would result if the smelter purchased his metals and held them for future sales. So long as this practice is followed, the method of accounting employed by the smelter and refiner should conform thereto and taxable net income should be based upon such a method.¹

The Treasury had argued that mining is an annual business and that the earliest purchases should be balanced against current sales. The miners stated that the above procedure is not the practice of the industry and not its method of accounting.

These representatives of the A. I. A., Brass Mill Products Association, and mining industry were very forceful in their arguments against use of a method of valuing inventories which did not conform with the best practices of the trade. A member of the Senate Committee on Finance offered the amendment for the use of Lifo in determining taxable income if such basis conforms as nearly as possible to best accounting practice in the trade and is regularly employed in keeping books and records of taxpayers. The amendment would have included all taxpayers; however, the Treasury Department objected on the grounds that with such a general amendment, the effect on revenues could not be estimated and that the number of taxpayers who could qualify could not be determined. Consequently, a substitute amendment was offered which restricted the use of Lifo to processors and fabricators of nonferrous metals and the leather industry.²

The amendment included in effect the wording recommended by

¹U. S. Senate, Revenue Act of 1938, op. cit., p. 485.

²"Inventories and Taxes," Journal of Accountancy, LXV (June, 1938), 457-462.
Maurice Peloubet.

There was still need of more efforts to gain wider use of Lifo, for there were other industries which could be benefitted also. Conservatism on the part of the Treasury is understandable; however, it is difficult to see why it did not readily accept a method so widely endorsed by leading experts. Also, it was evident that the use of Lifo would not reduce taxes over the cycle. It would seem that the Treasury's major concern would be the maintenance of its level of revenue in the long run, and that is accomplished with Lifo as well as FIFO.

Late in 1938, the A. I. A. was at the helm again for revision of the revenue law. Its recommendations to the United States Treasury included that the provisions governing Lifo be broadened. The A. I. A. stated that in Section 22(c) of the Internal Revenue Code, Congress intended that Lifo be recognized for income tax purposes and should require no specific provision by law. The Treasury objected to this on the grounds of administrative difficulty. Thus the following industries desirous of the elective method were excluded: textiles, meat packing, and petroleum.

Other objections to the Revenue Act of 1938 included the following:

1. The restriction was made that for nonferrous metals, Lifo would be confined to raw materials not yet included in goods in process or finished goods. With this restriction, the method would be of no value to this industry.

2. The enumeration of specific products and specific industries was unnecessary.

The A. I. A. thus believed that the 1938 provision for the
use of Lifo was too narrow and that the new bill should carry the statement that Lifo be used if it conforms to a recognized accounting practice.¹

The Revenue Act of 1939 provided that all taxpayers may use Lifo and did not restrict the use to raw materials. It required that application be made prior to adoption for a particular class of goods.²

**The Retailers' Fight**

Even though the 1939 law had not designated industries in which Lifo was to be applied, the majority opinion held that Lifo was not applicable to the retailing business. Lifo was considered most applicable to manufacturers, fabricators or converters in industries such as oil, rubber, textiles, leather, chemicals, lead, copper and other metal industries. It was believed that retailing did not meet the requirements for an industry suited to the use of Lifo, which are as follows:

1. The spread between raw material prices and finished goods prices should be relatively constant.

2. The investment in inventory should be large relative to other assets.

3. The inventory should consist largely of a few basic materials.

Conditions to the contrary were characteristic of the retail industry.


²Hutzler Brothers Company, 8 Tax Court 14 (1947), p. 25.
1. Inventories of retailers are not raw materials for processing and are not easily classified as capital equipment.

2. Retailers' inventories are reported in terms of dollars and not physical units.

3. The inventories are highly seasonal and have a high rate of obsolescence and stockturn.¹

In spite of the existing opinion, the retail trade believed that some relief should be given because of approaching war, rising prices, and resultant excess profits taxes. The Taxation Committee of the National Retail Dry Goods Association was designated to investigate the problem. The Taxation Committee presented a statement to the House Ways and Means Committee in 1941 recommending the establishment of reserves which would not be subject to income taxes and/or excess profits taxes. This recommendation did not receive favorable recognition.²

A significant development in 1941 was the suggestion by H. T. McAnly for the application of the Lifo principle to retailing. He recommended that for merchandise valued by the retail inventory method, the markon percentage could be applied to the ratio of increase of ending inventory over beginning inventory to produce the adjustment of the cost inventory. If there has been an increase in market price over the period, the increase will be applied only to the increase in inventory. This was the beginning of the retailers' push for Lifo.³

¹Malcolm P. McNair and Anita C. Hersum, op. cit., p. 164.
²Ibid., p. 165.
³Ibid., p. 167.
Exhibit I

Lifo Procedure Suggested by H. T. McAnly in August, 1941

<table>
<thead>
<tr>
<th>Retail</th>
<th>Cost</th>
<th>Markup</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning inventory</td>
<td>$150,000.00</td>
<td>$80,000.00</td>
</tr>
<tr>
<td>Purchases</td>
<td>385,000.00</td>
<td>209,000.00</td>
</tr>
<tr>
<td>Total</td>
<td>535,000.00</td>
<td>289,000.00</td>
</tr>
<tr>
<td>Ending inventory</td>
<td>200,000.00</td>
<td>108,000.00</td>
</tr>
</tbody>
</table>

Ending inventory cost (first-in, first-out) determined under retail inventory method adjusted to exclude amount of price increase of continuous investment portion (beginning inventory considered in ending inventory to the extent thereof).

Assume Retail Price Index of 125 at ending inventory date applicable to specific departmental merchandise. (100 equals price Index at beginning inventory date.)

Ending retail inventory at beginning-of-year price level

\[
\begin{align*}
\text{Ending retail inventory at} & \quad \ \text{Retail} & \quad \text{Cost} \\
\text{beginning-of-year price level} & \quad \frac{200,000.00}{125} & \quad 160,000.00 \\
\end{align*}
\]

Beginning-of-year total

\[
\begin{align*}
\text{Beginning-of-year total} & \quad 150,000.00 & \quad 80,000.00^a \quad 53% \\
\text{Quantity increase} & \quad 10,000.00 & \quad 55% \\
\text{Quantity increase at ending price level $10,000 \times 125 =} & \quad 12,500.00 & \quad 6,875.00^b \quad 55% \\
\text{Ending cost inventory on last-in first-out basis} & \quad 86,875.00 \\
\end{align*}
\]

(a) Beginning cost value on beginning quantity.

(b) Increase at average cost for year.

In seeking consideration for the use of Lifo, the Taxation Committee was aware of the following problems: (1) that Lifo was reported at cost and not cost or market, (2) that Lifo could not be used by firms which compiled interim reports on some other basis during the year, and (3) that the law.

\[\text{Malcolm P. McNair and Anita C. Hersum, op. cit., p. 171.}\]
required the application of Lifo in terms of units of goods. The problem of disallowing Lifo for a period when interim reports have been made on another basis was resolved through elimination of this stipulation in the Revenue Act of 1942.\(^1\) The Taxation Committee proposed as a solution to part of their problem the use of the dollar unit at a fixed price level, i.e., the development of a price index.\(^2\)

From this point the retailers began to consider development of a price index. The National Industrial Conference Board was appointed to formulate an adequate index of retail prices according to groups of related merchandise.\(^3\) As for meeting the requirement of a cost valuation of inventories, the retailers hoped that the Treasury would accept cost as determined by the retail method. This expectation was not realized, for the Treasury did not accept cost determined on this basis.\(^4\)

The American Institute of Accountants cooperated with the NRDGA in seeking the approval of Lifo for retailers in 1941. Both groups were aware that there would be need for considerable discussion with the Treasury Department before acceptance.

The NICB completed its index for the retailers in March,

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\(^1\)J. Keith Butters, *op. cit.*, p. 84.


\(^3\)Ibid., p. 175.

\(^4\)Ibid., p. 181.
1942. Although uncertain of Treasury acceptance, several retail companies began to use the NIGB index for tax and corporate purposes. Other firms used FIFO for tax reporting and adopted LIFO for other needs.

The Treasury was quite cooperative in assisting retailers in finding a suitable method of relief from the price spiral. Discussions were held between representatives of the retailers and the Treasury. In June, 1942, Mr. Randolph E. Paul of the Treasury presented to the House Ways and Means Committee a proposal for the establishment of a tax exempt inventory reserve. The reserve was based on the same principle as LIFO and was expected to have the same effect as LIFO. The privilege for use of the reserve was made retroactive to January, 1941 and to end at the close of five years following the end of the war emergency.

Mr. Paul's recommendations included the following:

1. That reserves be set up in periods of increasing price levels and that they be absorbed into profits in periods of price decline.

2. That Treasury approved indexes be used in establishing the maximum amount of reserves established without requiring specific identification of individual items of merchandise.

3. That any unused reserve at the end of the period be taxable at that time and that permission be granted to spread payment of the additional tax over a three-year period if desired.¹

Meanwhile, the ranks of the retailers increased as the American Retail Federation became active in the fight for Lifo. Mr. Earl B. Puckett, Chairman of the Tax Policy Committee, American Retail Federation, appeared before the Senate Committee on Finance during hearings for the Revenue Act of 1942. Mr. Puckett represented the American Retail Federation, Institute of Distribution, Limited Price Variety Stores Association, National Retail Dry Goods Association, and National Retail Furniture Association.¹

Mr. Puckett stated that a more accurate picture of results of operations would be gained from use of the Lifo principle of establishing cost for the valuation of inventories. In a business operating cycle, a transaction is not really closed and completed until the item has been replaced in stock. Thus, it would seem wise to consider cost for the replacement of merchandise essential to the operation of the business.

Reference was made to the need for minimizing inventory profits and the 1939 Revenue Act which approved Lifo for any company. A summary of Mr. Puckett's endorsement of the reserve plan recommended by Mr. Paul and the Lifo procedure follows:

1. Retailers were faced with fictitious profits in periods of fluctuating prices and should be entitled to the same protection as other companies.

2. The Lifo method, approved by Congress in 1939 more accurately reflects true profits for retailers than the Fifo principle.

3. The focus of the problem is on changes in price levels and their effects on valuation of inventories rather than the specific identification of individual items of merchandise.

4. For the retailing industry which has a heterogeneous inventory subject to frequent changes in design and specification a price index may be used to properly apply the Lifo principle.

5. The inventory reserve plan presented by Mr. Paul will be an adequate device and from the point of view of the Treasury it would afford complete assurance that no true profits will permanently escape taxation.\(^1\)

The major argument of the Treasury against Lifo was the difficulty of applying Lifo without specific identification of articles. The Senate Finance Committee did not accept the Paul plan because of numerous proposals for special reserve procedures. However, the Revenue Act of 1942 incorporated a measure of relief.\(^2\)

The Revenue Act of 1942 gave relief through provision for a five-year averaging period for the determination of wartime excess profits and income taxes. This was known as the carry-back provision. The law stipulated that losses incurred after December 31, 1941 could be absorbed by excess profits earned in the two preceding years. The losses would be applied to 1940 and then to 1939 excess profits and were to be offset by excess profits and normal profits respectively. Any taxable excess profits remaining after the loss carry-back adjustment

\(^1\)U. S. Senate, *Revenue Act of 1942*, *op. cit.*, pp. 1093-1094.

could be carried back to bring normal profits to the adequate level. If the entire loss was not absorbed by income and excess profits of the two preceding years, the balance could be applied against excess profits or income in the two succeeding years. The measure provided further that taxes paid on income or excess profits offset by carry-back or carry-over provisions would be refunded.

Significant changes were made in the carry-back plan by the Tax Adjustment Act of 1945. Butters reports these changes as follows:

First along with the repeal of the excess profits tax as of the end of 1945, it was provided that unused excess profits credits be repealed for taxable years beginning after December 31, 1946. To cover unused credits arising in 1946, the provisions of the excess profits tax were retained for one year beyond the repeal of the tax. The two-year loss carry-back still remained in 1949 as part of the tax law, though there has been considerable discussion of the advisability of repealing it to one year in connection with a lengthening of the carry-over period.

Secondly, the Tax Adjustment Act of 1945 overcame one of the serious defects of the carry-back provisions by permitting an accelerated recovery of overpayments of taxes resulting from the carry-back provisions. The taxpayers were thus assured of constructive receipt of their refunds in time to meet reconversion needs.

Butters has made a comparison of inventory reserves as proposed by the Treasury with carry-back provisions in relation

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2 J. Keith Butters, op. cit., pp. 315-316.
to their effectiveness in minimizing inventory profits. He concludes that the carry-backs were as effective a method as practicable. He states further that the carry-back provision was superior to the inventory reserve plan.\(^1\)

Evidently, the disallowance of the reserve plan and the substitution of the carry-back plan was in favor of the retailers. However, much work was left to be done to get approval of Lifo.

As was stated earlier, a few firms began using the NICB index in reporting Lifo for tax purposes. This bold step was met by strong opposition by the Bureau of Internal Revenue to the extent that many firms abandoned Lifo completely. Others who were assessed for tax deficiencies on the basis of Lifo paid the additional tax and filed protests and claims for refunds.

The Bureau rejected Lifo for the retailers on the grounds that the 1939 Act did not permit Lifo for retailers who could not determine at any inventory date the identity of their many types and classes of merchandise. This position was reversed by the Treasury in Decision 5504, March 20, 1946, in which Lifo for the retail trade was limited to situations where physical units in inventory were identifiable from one inventory date to another.\(^2\) This provision represented an opening for the retailers who could meet the specific identification test. For the vast majority, the privilege of using Lifo was to be delayed for a considerable period.

\(^1\)J. Keith Butters, *op. cit.*, p. 320.

A Test Case for the Tax Court

The retailers had exhausted arguments with the Treasury and the Bureau of Internal Revenue. The Tax Committee of the American Retail Federation and the Taxation Committee of the National Retail Dry Goods Association selected the Hutzler Brothers Company for a test case, which was tried before the Tax Court on November 13, 1945.

Hutzler Brothers had reported income by the Lifo method rather than the retail method which resulted in a difference in taxable income of $136,000 for the year ending January 31, 1942. The fundamental questions involved in the case were:

(a) must there be exact identity between the goods in the opening inventory and goods in the closing inventory, or may there be a comparison based on a reasonable classification of goods which are similar;
(b) must the computation of the inventory be exact to the last penny, the cost of each item being determined, or may the inventory be based upon procedures which are reasonable and practical and are generally accepted as producing a proper cost?\(^1\)

The Bureau of Internal Revenue relied heavily on the portion of the law which stipulates that authority is delegated to the Commissioner to determine what is the acceptable basis of inventory valuation. Certainly a group of associations comprising the entire retail industry were more qualified to judge adequate methods of accounting for the trade than the Bureau.

The argument on behalf of the Commissioner emphasized the following points:

\(^1\)Malcolm R. McNair and Anita C. Hersum, op. cit., p. 187.
1. The retail method is still in accord with best accounting practices for the retailer; the Lifo method is applicable to a limited group of firms.

2. The method used by Hutzler created a reserve for inventory valuation which resulted in a statement of inventory at less than current cost.

3. It is impractical for Hutzler Brothers to meet requirements of matching articles of goods on hand at the end of the year with similar articles of goods on hand at the beginning of the year, as specified in the regulations.

4. Hutzler Brothers had failed to adjust to cost opening inventory on which markdowns had been taken. The company did not meet the requirement for inventorying goods at cost.

5. The regulations make no provisions for use of a price index. The NICB index was not acceptable because it was not shown to be accurate or representative of department stores generally and of Hutzler in particular, either as to composition of inventory by commodities and proportions thereof or as to the price movements of all commodities.\(^1\)

The Hutzler argument is summarized as follows:

1. In the Revenue Act of 1939 the right to use Lifo was extended to all taxpayers. No regulations have been issued as a guide for the application of Lifo to retailers.

2. The Commissioner is unreasonable in requiring specific identification of goods. The classification by departments and use of the retail method in reporting cost of inventories has been accepted by business men, bankers, the accounting profession and reserve authorities. The problem for taxation was one of finding a method for measuring goods in the closing inventory against goods in the opening inventory.

3. Lifo should be applicable in determining an aggregate valuation of an investment in an inventory of related goods.

4. The use of the dollar as common denominator in valuing inventory makes the application of Lifo practical.

It can be determined whether there is an increase or decrease in inventory of one year over another. The same objective is achieved on the basis of a price index for similar items as in comparing identical items.

5. The NICB index was more suitable than indexes which would be computed by each firm.¹

In his opinion in favor of Hutzler Brothers the Judge stated:

1. The Commissioner's requirement of identification of specific articles was not logical and that legislative enactment did not support the argument.

2. The provisions of the 1939 Act were not to be restricted to the industries which appealed for its enactment.

3. The use of the dollar as a common denominator in valuing inventories is a requisite of the aspect of department store accounting which relies for its inventory volume in a statement in dollars alone.

4. The method employed by Hutzler is not contrary to recognized principles of retail inventory practice and does not support the argument that Congress did not intend Lifo for retailers.

5. The adaptation of the Lifo theory to inventories maintained in terms of dollars through the approach generally employed by the present petitioner is permissible and proper within the provisions of the Internal Revenue Code.

The NICB index was not approved, and Hutzler Brothers agreed to use an unweighted index of its own prices department by department.² The Hutzler decision was made January 14, 1947.

The Hutzler Brothers decision paved the way to the issu-

²Ibid., pp. 191-193.
ance of final regulations for retailers to use Lifo. McNair records the events prior to final approval as follows:

Many months elapsed before department stores were accorded formal permission to use Lifo. On December 23, 1947, the Commissioner of Internal Revenue published in the Federal Register a proposed amendment to the income tax regulations authorizing retail businesses to employ the Lifo inventory method, provided that suitable statistical procedures were used. Approximately two weeks later, on January 7, 1948, the BLS released its department store inventory price indexes for the period through 1947.

...On March 4, official approval was given to Treasury Decision 5605 making the necessary amendments of income tax regulations to accord the use of the elective method to retailers; and a few days later Income Tax Mimeograph 6244 was issued, explaining the application of these amendments.¹

Significant points in the Mimeograph were as follows:

1. Approval of the BLS index or a suitable index compiled by the firm.

2. The requirement for retailers to use a net markon rather than a gross markon percentage, to be computed as the difference between cost and retail after deduction of markdowns from the retail.²

This was the go signal for retailers to begin using Lifo, and resulted in many firms reporting their incomes for the period on that basis.

The decision in the Hutzler case did not resolve all issues in the application of Lifo in retailing. The following are problems not included: the application of Lifo to companies not using the retail method; the use of cost indexes as well as

¹Malcolm P. McNair and Anita C. Hersum, op. cit., p. 194.
²Ibid., p. 195.
retail indexes, and the level of departmentalization required. These problems were dealt with in the Basse and Sweeney cases.

Basse and Sweeney were in the grocery chain and wholesale grocery business respectively. The Court approved for both companies the Lifo valuation of warehouse stocks at cost in terms of the dollar as unit of measurement. The extent of departmentalization was approved for both—twenty-nine groups in the Basse case and thirty-nine in the Sweeney case. The companies' own cost records were used to establish cost price changes and to determine physical inventory changes. For the Basse business, there was disapproval of the application of an overall internal composite cost price index, based on warehouse stocks to the undepartmentalized cost stocks of retail stores.¹

As time passed the door was open wider to retailers to avail themselves of the elective method. For the near decade since 1939 the retailers were involved in pursuit of their rights under the new revenue law. After obtaining approval for the use of Lifo, the retailers were faced with the problem of developing calculation procedures. Although various procedures could be employed, the object of all such methods was to determine "the amount of inventory at base-year prices and the amount of the increment or decrement, also at base-year prices, that is represented in the current inventory." All of the procedures are also in agreement on placing Lifo cost value on

¹Malcolm P. McNair and Anita C. Hersum, op. cit., pp. 196-197.
any increment.¹

Lifo Presents a Problem—Involuntary Liquidation

As the use of Lifo broadened, problems arose which were not anticipated. Because of the war, certain firms experienced difficulty in obtaining raw materials. As a result, many companies were forced to deplete their inventories. Their purchases were not comparable to their sales and incomes were subject to excess profits taxes. A portion of the incomes ordinarily would be used for replacement purposes. Such depletion of inventories has been termed "involuntary liquidation."

This is significant for Lifo because one of the requirements of Lifo is to maintain a basic inventory.

The Revenue Act of 1942 defined involuntary liquidation as a decrease in the closing inventory occurring for specific war reasons in a quantity of merchandise of the same kind and description as present in the opening inventory.² Many firms were affected by this condition and sought relief from the government.

Typical among those making such appeals was the Armstrong Cork Company of Lancaster, Pennsylvania. Mr. George Arisman, the Comptroller of that company, presented a statement before the

¹Malcolm P. McNair and Anita C. Hersum, op. cit., p. 229.

Senate Committee on Finance during hearings for the Revenue Act of 1942. Mr. Arisman reported that the Armstrong Cork Company relied heavily on foreign trade for much of its raw materials. Because of unforeseeable shipping conditions occasioned by the war, Armstrong was unable to keep quantities of inventories at established levels. It thereby incurred paper profits during the first half of 1942 in the amount of $600,000 subject to the highest rate of taxes. Because of the outlay of cash involved in meeting the excess profits tax rate, the company would not have funds available to replace inventory when shipping conditions would allow.

Mr. Arisman recommended as a relief measure the creation of an emergency last-in, first-out fund which would be used to replace depleted quantities when conditions would permit.¹

Relief from excess profits taxes due to involuntary liquidation was given with the passage of the Revenue Act of 1942. The Act provided that firms subject to involuntary liquidation could elect to have their taxable income adjusted for the year of liquidation. The Act stipulated measures to be taken in case of an increase or decrease in cost of goods depleted. The net effect to be achieved was to take the replacement goods into purchases and inventories of the year of replacement at the inventory cost basis of the goods previously liquidated. Through passage of this Act, the taxpayer was relieved of excess

profits taxes which might have occurred through use of Lifo in an unfavorable period.\footnote{1}

Though this problem arose, enthusiasm for Lifo was not dampened. During the hearings, when asked why the Armstrong Cork Company adopted Lifo, Mr. Arisman gave very strong support for it and stated that the company still considered Lifo as valuable in reporting taxable income.\footnote{2}

During the Eighty-first Congress, 1951, H. R. 9794 was passed which extended the time for replacing goods liquidated during the World War II years and provided for the replacement of goods liquidated during the Korean conflict. It stipulated that relief would be given for liquidations during other emergencies which hamper foreign trade as well as during the war.\footnote{3}

**Summary**

The foregoing account has traced the status of the base stock principle in income tax accounting from the meager efforts of the Kansas City Structural Steel Company to the united forces of trade associations and the American Institute of Accountants. The industries appealing to the government presented adequate evidence to support the fact that Lifo was suited to their particular processes and that it was accepted as good accounting


\footnote{3}Malcolm P. McNair and Anita C. Hersum, \textit{op. cit.}, p. 200.
practice. The income tax officials gradually conceded to the
well grounded demands of practical business accounting from its
grant of relief to tobacco producers in 1920 to the approval
of the use of Lifo for all in 1939 and finally, approval of
the price index facilitating the use of Lifo for retailers
in 1947.

In view of the fact that the American Institute of Account-
ants serves an important function in making significant recom-
mendations to the Bureau of Internal Revenue, it would seem that
Lifo would have been readily accepted. Further evidence of
inconsistency on the part of the government is (1) approval of
the average method for tobacco only in 1920 when other indus-
tries had similar problems, (2) approval of matching gains and
losses for cotton and wheat only in 1936 and (3) in excluding
needy industries without firm reasons in the 1938 Act. In the
final analysis, accountants and business men have been grateful
for such inconsistencies, for significant foundation was laid
for recognition of the base stock principle.

The retailers endured their task of achieving approval of
Lifo to the point of destroying the Commissioner's major argu-
ment—the requirement of specific identification of goods.
From the retailers' efforts came the use of the price index in
adjusting inventories and the dollar-value method.

In the establishment of any new law, it is not an easy
matter to perceive all problems which may be incurred or to
cover all conditions under which the law will be applicable.
Such was the case with Lifo in general and for retailers. The Hutzler decision opened the way for use by retailers. However, issues remained to be resolved and were taken care of in further court cases, the Basse and Sweeney cases. As for unforeseen problems, the matter of involuntary liquidation could not be determined until the method was employed. Moreover, this case occurred because of the war emergency. Remedy for the situation was sought and gained through passage of the Revenue Act of 1942 and enactment of legislation in 1951.

Even though problems were encountered from the use of Lifo, its value to firms in a fluctuating economy was maintained.
CHAPTER V

APPRASIAL OF LIFO

Any problem as controversial as Lifo is deserving of further evaluation. In this respect, a backward look at the original aim of Lifo is needed. Lifo began receiving attention when the major accounting aim shifted from balance sheet emphasis to income statement emphasis. The recognition of the value of Lifo in more adequately reporting income is reinforced when note is taken of its adoption long before it was allowed for tax purposes. Because the controversy with the courts was mainly concerning the tax issue, the possibility of tax saving in many instances foreshadows other important advantages.

Accountants have found that Lifo more correctly states income than Fifo because it removes inventory profits caused by price fluctuations. The modification of the effects of fluctuations in reported income leads to wiser business decisions, more even tax payments, and a more stable business cycle. Because the use of Lifo matches current purchases with current sales, there is a more meaningful statement of income and Lifo achieves the current accounting aim—emphasis on the operating statement. Lifo is thus a major step in the evolutionary development of sound accounting.¹

As stated in Chapter III, the Lifo method produces more desirable cash and psychological effects than Fifo. The cash position for the firm is the same with both methods. The Fifo method shows income in adverse relation to available cash, while Lifo brings stated profits more in line with cash. This leads to more rational actions on the part of management, stockholders, the government, and the public.

Management decisions on dividends, wages, and plant and equipment expansion are influenced by the status of reported income. The greater the reported profits the more likely management will make decisions for increases in these expenditures. When these reported profits include inventory profits, adverse results will develop. Through the use of Lifo which produces a more accurate statement of income, such expenditures will be made when the business is in position to pay them. Stockholders will not press for dividends and labor will not be able to point to huge earnings which may not all be real earnings.¹

In regard to wage demands by unions, it has been found that ability to pay has not been used strongly in wage negotiations. However, there is no doubt that the presence of huge profits strengthens labor's bargaining position. Wage policy analysts, union representatives, and sometimes government officials have on some occasions misinterpreted profits figures and recommended wage increases without price increases. In event such recom-

mendations are adhered to, profits on traditional methods would include inventory profits, and these companies would be faced with paying wage increases for which cash is unavailable. Companies on Lifo will reflect a profit showing more in line with funds and may escape incompatible wage increase demands.1

The significance of Lifo for policy decisions such as pricing and purchasing is also deserving of mention. Two criteria for pricing decisions are market conditions and profits.2 Through use of Lifo, management will price goods more in line with current market price. Lifo removes the effect of inventory price change from the profit and loss statement. Thus management will not be reluctant to lowering or raising prices as market conditions demand.3

On the basis of the profits criteria, in times of rising prices, profits computed by traditional methods are higher than those computed by Lifo. If a firm sets prices on the basis of profits computed by traditional methods, prices will seem unreasonably high. Because of public reaction, management would be reluctant to raise prices as high as these expected returns demand. Prices would probably be made lower than the current market demands. If Lifo is used, profits will be stated at a more realistic level and management will be more prone to raise

2Ibid., p. 122.
prices in keeping with the profit level. During periods of falling prices, the use of Lifo would relieve management of reluctance to lower prices to the desired level.

The following statement has been made in reference to regulating prices over the business cycle.

...Prices of finished goods will tend to rise more quickly on the uptrend, thus absorbing the increased purchasing power represented by increased replacement costs before it does any harm. Similarly, management will not be so pessimistic about necessary price reductions on the downtrend, because they will know that their own replacement costs are falling also, and that profits on the Lifo principle will not be as low as they would be on the conventional accounting basis.

As for the impact of Lifo on purchases, there would be a tendency toward stabilization of this phase of operations. Fluctuating inventories may have an undesirable effect on purchases and Lifo firms may find it wise to regulate purchases closely near the end of the fiscal year. If the volume of goods is reduced and the goods are sold at prices much higher than their acquisition prices, there will be an increase in taxable income. In order to avoid an increase in taxes, there is the incentive to maintain inventories at constant volume. A possible tax saving also leads to a firm's decision not to increase inventories when prices are high. Since these goods will be carried at their acquisition cost, there will be an

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increase in taxable income. These examples illustrate the possibility of more stable inventory holdings as a result of the use of Lifo.¹

In terms of aiding fiscal policy decisions, the more realistic statement of income would lead authorities to wiser decisions in manipulating tax rates over the business cycle.²

**Lifo and Economic Stability**

Authorities hold that the Lifo method is in agreement with the economic concept of income and aids maintenance of real assets. When considering the role of inventory in the determination of income, economists define income as the gain after allowing for the maintenance of the opening inventory. Likewise, profit for economists is that excess after maintaining the opening money capital.³ The manner in which Lifo fits in with the concept of keeping real capital intact is described as follows:

If a certain amount of initial capital is provided by the proprietor or stockholders, and part of that initial capital is invested in inventories, then real capital can be kept intact if replacements of the initial inventories are valued at the same price level as those initial inventories. In such a case, a fixed amount of money capital is matched by fixed unit values attached to the inventories in which that capital is invested. That, in effect, is the Lifo method, and it maintains real capital intact by virtually freezing the values attached to a constant volume of stocks.⁴

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¹ J. Keith Butters, *op. cit.*, pp. 118-119.


Moreover, Lifo is valuable when measuring national income because the economic principle of keeping capital intact is accepted as a standard of income measurement, principally when considering the whole national economy.¹

Lifo is considered a practical solution for one phase of the problem arising from monetary instability. Companies utilizing Lifo move one step closer to reporting real profits. Lifo approaches part of the problem because it affects prices of specific commodities. It eliminates the profit from inventory price increases thus eliminating the resultant demands by the tax collector, the profit-sharing employee and the stockholder. Lifo is deterred from more effectiveness because of the fluctuation of inventory volumes from one period to another. In spite of this Lifo does move toward more economic stability.²

**Actual Effects**

Much has been written on the proposed accomplishments of Lifo. In order to get a true picture of results of its use, it is necessary to examine actual situations in which the method has been employed. Up to this point, a few investigations have been made. Lifo has hardly been in widespread use for a period of ten years. Thus, there has not been opportunity to adequately determine its effects.

¹K. Lacey, *op. cit.*, p. 203.
Lifo as a principle of inventory accounting has made significant progress in professional accounting circles. In comparison with Fifo-cost-or-market, Lifo is equally acceptable. Though the use of Lifo is increasing, it is not anticipated that this method will completely displace Fifo.¹

Progress toward general adoption of Lifo made headway during the World War II years. In early 1951, there were still signs of progress. Exhibit II shows the relative use of Lifo, Fifo and average cost for the period 1947-1951.²

Exhibit II

<table>
<thead>
<tr>
<th>Year</th>
<th>Lifo</th>
<th>Fifo</th>
<th>Average Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>171</td>
<td>146</td>
<td>106</td>
</tr>
<tr>
<td>1950</td>
<td>137</td>
<td>131</td>
<td>120</td>
</tr>
<tr>
<td>1949</td>
<td>141</td>
<td>137</td>
<td>132</td>
</tr>
<tr>
<td>1948</td>
<td>137</td>
<td>120</td>
<td>127</td>
</tr>
<tr>
<td>1947</td>
<td>104</td>
<td>109</td>
<td>112</td>
</tr>
</tbody>
</table>

The American Institute of Accountants conducted a survey of 525 corporate reports and found the following industry groups represented among those using Lifo: meat packing, textiles, rubber, chemicals, big steel, building materials, beverages, tobacco, shoes, paper, general machinery, transportation equipment, nonferrous metals, oil, retail, and miscellaneous manufacturing.³ In addition to these industries, Butters' survey,

¹Malcolm F. McNair and Anita C. Hersum, op. cit., p. 330.

²Joseph A. Mauriello, op. cit., p. 9.205.

made about the same time, reveals use of Lifo by food companies other than meat packers. Many of the companies surveyed confined Lifo to certain segments of their inventories. The use of Lifo was found to be concentrated among large concerns.\(^1\)

John Van Pelt reports on a survey implemented for the purposes of determining the extent to which Lifo is used for advantages other than tax savings. Every industry group was included in the twenty-nine replies received from a sample of sixty companies. The results of the study indicated that Lifo had advantages far beyond the tax savings feature. The survey also revealed that industrialists upheld Lifo as the only method that approached an allied system of costing to merchandising responsibilities such as replacement costing.\(^2\)

In regard to a tax savings it has been found that companies using Lifo have received a tax advantage. There have been arguments against Lifo as a device for relief from high taxes because Lifo reported earnings are higher in periods of deflation than inflation. Counter to this argument has been that because of a firm's more liquid position at such times there should be no difficulty in meeting these tax payments. A second factor is that during periods of deflation taxation is usually lower.\(^3\)

\(^1\)J. Keith Butters, _op. cit._, pp. 269-299.


\(^3\)Malcolm P. McNair and Anita C. Hersum, _op. cit._, p. 333.
McNair reports that retailers possibly received a net tax advantage through adoption of Lifo. This conclusion was based on the assumptions that (1) income is taxed at higher rates during years of price inflation than deflation, (2) the operation of Lifo over a complete cycle results in an equalization of profits and (3) Lifo profits are equal to Fifo profits over the cycle.\(^1\) Other authorities have stated without reservation that Lifo has given a tax advantage.\(^2\)

*Business Week* conducted a survey of companies on Lifo in 1951 to obtain reactions of management to Lifo. The following were typical reactions of management on the advantages of Lifo.

1. The most important reason for shifting was the probability of a big tax savings.

2. Lifo eliminates big inventory profits that would require taxes on millions of dollars not really earned.

3. Lifo tends to reduce earnings in a period of inflation and increase them in a depression period, thereby leveling off peaks and valleys over a period of several years.

4. Lifo minimizes the effect of inventory profit during periods of increasing prices and of inventory loss during periods of declining profit.\(^3\)

From the above it is seen that a tax saving is the outstanding reason for adopting Lifo and that industry attests to this achievement. It is also evident that management has

\(^1\)Malcolm P. McNair and Anita C. Hersum, op. cit., p. 237.


experienced the stabilizing effects of Lifo over the business cycle. These stabilizing effects would lead to wiser business decisions. With the limited knowledge of real experience available it may be concluded that Lifo accomplishes what its proponents predicted.

The Current Controversy

Though the trend has been toward general acceptance of Lifo, there has been very strong opposition to the method. It has been argued that Lifo is inadequate because of the effect of involuntary liquidation, that it contributes to instability and that it destroys the value of the balance sheet.

The lack of a free market for goods at times in our economy may result in unwarranted liquidation of Lifo inventories. Legislation of 1951 provided some relief from this. However, adequate provision has not been made for involuntary depletion of inventories due to swings in the business cycle. It has been recommended that this problem be countered by legislation which would take into consideration the effects of cyclical demand. Regulations could be made which would permit the deduction in a current tax year of reserves to provide for replacement of inventories at established Lifo levels, computed on the basis of current prices, with replacement required within a relatively short span of years. The effect would be an allowance for the maintenance of a true base inventory, measured by actually attained levels.¹ The following statement

¹John V. Van Pelt, III, op. cit., p. 455.
emphasizes the above contention: "From the standpoint of soundly determining income, such a provision is necessary in order to minimize profits or losses on liquidations of inventory which are both temporary and uncontrollable."¹

In regard to the balance sheet, the major grievance has been that Lifo gives a gross understatement of inventory values which causes misleading information regarding the current assets. Because of this there is a weakening of the comparability of financial statements of different companies or of one company over a period of years.²

Other significant arguments are as follows:

1. Lifo inventory figures bear no relationship to current figures and would not afford an accurate calculation of turnover or comparison of cost of sales with inventory.³

2. The significance of the current ratio is destroyed.⁴

3. The inventory value has no relation to currently realizable value.⁵

Counter to the argument that Lifo destroys the balance sheet have been proposals made to bring the balance sheet up to date. As for the inadequacy of the Lifo balance sheet

¹John V. Van Pelt, III, op. cit., p. 455.


³Ibid.


⁵Ibid.
for comparison purposes, it has been recommended that the accounting profession look ahead to a more extensive use of Lifo. The adoption of the dollar value method of inventory pricing has made it useful for any industry.¹

Suggested means of correcting the Lifo balance sheet are as follows:

1. Replacement values of Lifo inventories should be reported on the balance sheet. The balance sheet would then be more useful to readers and analysts of financial statements. Some accountants believe that disclosure would destroy the effectiveness of Lifo.²

2. Where Lifo is used inventories should be stated on the balance sheet at net realizable value, or upon the basis of the Fifo computation, and that the excess of such amount over that resulting from the Lifo computation should be treated as a deferred profit after provision for the deferred tax with appropriate explanation.³

3. Take the long term view of regarding a certain portion of inventories as fixed assets. Separate base inventories from current inventories and this will correct the distortion of current assets caused by including the fixed asset element in the statement of inventory.⁴

A fourth proposal is to construct the balance sheet in such a manner that all assets and liabilities will be expressed in current values. This is done by reducing earnings to cover the inventory cost increase and adjusting accrued depreciation

¹H. T. McAnly, op. cit., p. 696.


³Anson Herrick, op. cit., p. 493.

⁴Ibid., p. 494.
charges against earnings to reflect depreciation recovered on a current dollar basis.\(^1\) The inventory is adjusted to the Lifo cost or market basis after allowance for income taxes. The inventory is increased by the amount of the net additional of excess inventory over Lifo after applicable income taxes. The net additional to inventory is offset by a credit to a reserve to prevent the impairment of capital covering the inventory cost increase.\(^2\)

Following is the balance sheet proposed by McAnly, which will put the entire balance sheet on a current basis.\(^3\)

**Exhibit III**

**ASSETS**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$150,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>$250,000</td>
</tr>
<tr>
<td>Inventory--Lifo Cost</td>
<td>$400,000</td>
</tr>
<tr>
<td>(Excess of lower of incurred cost or market over Lifo ($300,000) less applicable fed. income taxes ($156,000))</td>
<td>$144,000</td>
</tr>
<tr>
<td>Plant assets</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less all. for depr.</td>
<td>$500,000</td>
</tr>
<tr>
<td></td>
<td>$1,444,000</td>
</tr>
</tbody>
</table>

**LIABILITIES**

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable</td>
<td>$400,000</td>
</tr>
<tr>
<td>Capital stock</td>
<td>$200,000</td>
</tr>
<tr>
<td>Reserve to Prevent Impairment of capital covering inventory cost increase</td>
<td>$144,000</td>
</tr>
<tr>
<td>Earned surplus</td>
<td>$700,000</td>
</tr>
<tr>
<td></td>
<td>$1,444,000</td>
</tr>
</tbody>
</table>

The Lifo cost or market principle has further implications than the protection of the balance sheet. The application of

\(^1\)H. T. McAnly, op. cit., p. 699.

\(^2\)Ibid., p. 698.

\(^3\)Ibid., p. 699.
cost or market to Lifo would give firms some protection from the effects of freezing the beginning price level. Companies would then adopt Lifo prior to a downswing as well as an upswing. Further argument in support of this principle is that firms employing it would only be retaining the privilege they now have under Fifo. The companies would be permitted no greater write-offs against profits in periods of price decline than would be permitted if they continued to operate on the Fifo basis.¹

The American Institute of Accountants recommended to the tax officials that the Internal Revenue Code be amended to permit taxpayers using Lifo to value their inventories at lower of cost or market while the Excess Profits Tax Act of 1950 was in force and for five years thereafter.² This proposed amendment to the Internal Revenue Code received support from the Tax Committee of the National Association of Manufacturers; Department of Manufacture Committee of the U. S. Chamber of Commerce; the American Retail Federation; the American Iron and Steel Institute and the Commerce and Industry Association of New York.³

The above indicates that there is dissension among accountants concerning the appraisal of Lifo and that Lifo advocates

¹H. T. McAnly, op. cit., p. 695.
²Maurice Moonitz, op. cit., p. 685.
³John V. Van Felt, III, op. cit., p. 455.
are still urging legislation to make Lifo more effective and to broaden its utilization. The Lifo problem seems an unending controversy.

Conclusions

The major focus of this thesis has been an investigation of the problems involved in revising inventory accounting to effect a more accurate income statement which would in turn lead to more economic stability and less taxes on unearned income. There was first the recognition that inventory accounting did not coincide with the current accounting aim—more accuracy for the income statement; secondly, the recognition of the need for the elimination of excess tax payments on income including inventory profits; and thirdly, the actual campaign for governmental approval. Major conclusions of this thesis are made in terms of accounting in general, inventory valuation, and the comparative effectiveness of Lifo and Fifo. These conclusions are as follows:

1. Lifo matches costs for a period with income for that period and places the income statement on a more current basis. There results a more accurate statement of income. Accountants have made a beginning toward achievement of the new emphasis.

2. In the area of inventory valuation, the recent trend has been a shift toward the use of Lifo instead of the traditional method—Fifo-cost-or-market.

3. In terms of comparative effectiveness, evidence holds that Lifo is more desirable for reporting income than Fifo. Lifo leads to better business decisions and more efficient governmental reporting, which affect the entire economy.
The following minor conclusions are also indicated:

1. Because of the necessity of governmental approval of Lifo for tax purposes which thereby broadened its use, it may be concluded that the government has a significant effect on changes in accounting policy.

2. Taxation has caused emphasis to be placed on the effect of published accounting statements and has therefore lead accountants to develop sounder accounting procedures and a higher level of efficiency.

The future of Lifo hinges on extensive study of its actual effects.¹ Beyond the realm of inventory valuation, the problem suggested for further study is the extent of governmental influence on accounting practices.

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