THE LIFO COALITION

1325 G Street N.W., Suite 1000, Washington, DC 20005 TEL: 202-872-0885

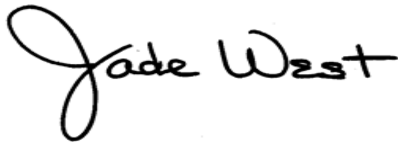
August 12, 2011

Re: File Number 4-600
Comment with Respect to May 26, 2011, Staff Paper on Exploring a Possible Method of Incorporation Under Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers

Dear Sir or Madam:

I am writing on behalf of the LIFO Coalition to submit the attached comment in response to the request for comment included in the above-referenced Staff Paper. We appreciate the opportunity to comment on this paper. If you have any questions or need information about our Coalition, please contact me at your convenience.

Sincerely,



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

THE LIFO COALITION
1325 G Street N.W., Suite 1000, Washington, DC 20005 TEL: 202-872-0885

RESPONSE TO REQUEST FOR COMMENT INCLUDED IN MAY 26, 2011, SECURITIES AND EXCHANGE COMMISSION STAFF PAPER

This comment is in response to the comment request included in the May 26, 2011, Securities and Exchange Commission (SEC) staff paper regarding a possible method of incorporation of International Financial Reporting Standards ("IFRS") into the current financial reporting system for U.S. issuers (the "Staff Paper"). The comment is filed on behalf of the LIFO Coalition (the "Coalition"), which represents businesses and trade associations of every size and industry sector that employ the last-in, first-out ("LIFO") accounting method. The LIFO Coalition was organized in April 2006, when LIFO repeal was first proposed in the Senate as a revenue offset to fund unrelated policies. Since then the Coalition has grown to include more than 120 members: trade associations representing every sector of American industry -- manufacturing, wholesale distribution, and retailing -- and companies both large and small. The Coalition's mission is to preserve the option of companies to value their inventories pursuant to the LIFO method for federal income tax purposes.

Interest and Perspective of the LIFO Coalition

The Coalition's interest in the Staff Paper -- and, in fact, in any process or procedure that the Securities and Exchange Commission (the "SEC") might adopt to incorporate IFRS into the U.S. financial reporting system -- is limited to the impact of IFRS on the use of the LIFO inventory method. The Coalition's interest in the treatment of the LIFO inventory method under IFRS is related to the so-called "LIFO conformity requirement" of Sections 472(c) and (e)(2) of the Internal Revenue Code (the "Conformity Requirement").

The Conformity Requirement provides that a taxpayer may not use the LIFO method of inventory valuation for federal income tax purposes unless the taxpayer also uses LIFO as its primary method of inventory valuation in reporting the results of its operations in its annual reporting statements to shareholders, creditors, etc. Since IFRS does not allow use of the LIFO method for financial reporting purposes, any requirement by the SEC that U.S. issuers adopt IFRS for such purposes means that issuers will be forced to violate the Conformity Requirement. Violation of the Conformity Requirement subjects the violating taxpayer to termination of its LIFO election for federal income tax purposes. That in turn, as will be discussed more fully below, may expose the taxpayer to serious adverse tax consequences immediately and in future years.

The LIFO Coalition's Previous Filing with the SEC

The LIFO Coalition expressed these concerns in an earlier filing with respect to the SEC's Road Map for the Potential Use of Financial Statements Prepared in Accordance with International Reporting Standards of U.S. Issuers (the "Road Map").[1] The Coalition also noted in that comment, however, that notwithstanding the Coalition's concerns, the Treasury Department has adequate authority to remedy those concerns by excusing violations of the Conformity Requirement in certain circumstances. The Coalition urged the SEC to discuss this matter with the Treasury Department before deciding whether to require U.S. issuers to use IFRS in their financial statements. The purpose of that discussion, as the Coalition proposed it, would be to reach an accommodation that would not result in the termination of the use of the LIFO

[1] Letter from The LIFO Coalition to Florence E. Harmon, Securites & Exchange Comm'n (Feb. 18, 2009), *available at* http://www.sec.gov/comments/s7-27-08/s72708-45.pdf.

method for federal income tax purposes for U.S. issuers in the event issuers were required to adopt IFRS and thereby abandon LIFO for financial reporting purposes.

Since that time, the Coalition has reviewed and refined its legal analysis regarding the Treasury Department's authority, and it is still persuaded that the Treasury Department is authorized to allow taxpayers to continue to use LIFO for federal income tax purposes even if the SEC fully incorporates IFRS into the U.S. financial reporting system. The Coalition has conveyed this analysis directly to the Treasury Department and has requested the Treasury Department to use its authority to avoid the tax consequences that have prompted the Coalition's concern.

The Coalition has no assurance, however, that the Treasury Department will grant the Coalition's request. Even if the Treasury Department accepts the Coalition's legal analysis that it has the authority in question, it might nonetheless decline to exercise that authority. The Coalition, accordingly, has decided to file this comment and urge the SEC to take additional action not requested in its earlier filing. That said, the Coalition also continues to urge the SEC to explore with the Treasury Department the accommodation referenced in the Coalition's Road Map filing.

The Requested Relief

As in its earlier filing, the Coalition takes no position on whether the SEC should require U.S. issuers to use IFRS in their financial reporting. The position the Coalition now takes, however, is that even if the SEC decides to take that step, the SEC should allow those issuers to continue to use LIFO as their primary method of inventory accounting in their financial statements. In other words, the Coalition is requesting that the SEC provide a "carve-out" for

LIFO accounting in the event that the SEC otherwise decides to require U.S issuers to adopt IFRS.

The Coalition notes that country-by-country carve-outs from a more standardized version of IFRS accounting are by no means unusual among adopters of IFRS. In most cases, countries that have adopted IFRS retain a national standard-setting body that has jurisdiction over accounting standards. That body may adopt a "version" of IFRS that diverges in some way from IFRS as adopted by the International Accounting Standards Board (the "IASB"). According to one recent study, a majority of the countries that require the use of IFRS accounting have adopted a local version of IFRS, rather than IFRS as adopted by the IASB.[2] Moreover, according to Jack Ciesielski, publisher of The Analyst's Accounting Observer, less than 16 percent of the world's markets overall use a pure version of IFRS as the IASB has published it.[3]

In the same vein, Robert Herz, the former Chair of the Financial Accounting Standards Board, recently noted that while progress has been made toward worldwide acceptance of common accounting standards, the four major economic powers (including the U.S.) have yet to commit to full acceptance of IFRS.[4] Herz stated that India plans to adopt IFRS but is implementing an endorsement process that has resulted in "'loads of changes to the standards to better suit the Indian environment and culture.'"[5] With regard to China, Herz indicated that while the country's accounting standards are modeled on IFRS, the Chinese wish to maintain

---

2 *See* PricewaterhouseCoopers, *IFRS Adoption by Country* (Mar. 2011), *available at* http://www.pwc.com/en_US/us/issues/ifrs-reporting/assets/ifrs_country_adoption.pdf.

3 S*ee* Dena Aubin, *Analysis: Doubts Emerge Over U.S. Move to Global Accounting* (July 25, 2011), *available at* http://www.reuters.com/article/2011/07/25/us-usa-tax-convergence-idUSTRE76O1N220110725.

4 *See* Thomas Jaworski, *Major Economies Remain Hesitant to Fully Embrace IFRS, Former Official Says*, Doc. No. 2011-17282, 2011 TNT 154-3 (Aug. 10, 2011).

5 *Id.*

flexibility for their businesses by allowing the use of U.S. Generally Accepted Accounting Principles ("GAAP") for some aspects of the country's financial reporting. And with respect to Japan, Herz observed that the country currently permits the use of IFRS, but that many large multinational companies based in Japan continue to use U.S. GAAP. Japan's recent natural disasters have led officials to postpone a previously planned decision on whether to require a mandatory switch to IFRS in 2016.[6]

The Coalition requests the SEC to follow this pattern of divergence from IFRS to accommodate specific national needs. Thus, if the SEC ultimately decides to require the use of IFRS by U.S. issuers, the Coalition urges it also to provide a carve-out to permit the continued use of the LIFO method in the issuers' financial reports.

Reasons in Support of the Request

There are essentially three reasons that the Coalition believes such a carve-out is warranted. These are summarized below.

(1) The Conceptual Soundness of the LIFO Accounting Method -- The first reason is that a carve-out for the LIFO method will preserve for both financial reporting and tax purposes the accounting method that is typically the most conceptually sound for the large majority of U.S. industries that experience rising inventory costs over time. The LIFO accounting method assumes that the cost of the inventory first sold by a company is the cost of the inventory last acquired or produced by the company. The most-used alternative accounting method, the first-in-first-out ("FIFO") method, assumes the contrary -- that the cost of the

[6] Herz also stated that Japan is looking to what the U.S. will decide on IFRS and that the U.S. decision will be "'very important to the future of whether or not we can get to at least more common standards[.]'" *Id.*

inventory first sold is the cost of the inventory first acquired or produced. For the many industries that experience rising inventory costs over the years, the application of LIFO typically results in reporting lower profits on financial statements and lower taxable income under the Internal Revenue Code than would occur under FIFO. While the LIFO method matches revenues that have been increased by inflation against similarly inflated inventory costs, the FIFO method compares those revenues to earlier inventory costs that have not been similarly inflated.

Put another way, a principal advantage of LIFO over FIFO is that LIFO takes into account the increased costs that are associated with *replacing* inventory during inflationary periods. To illustrate, a company that replaces its inventory during such periods at prices that approximate its selling price is not a profitable company, and yet financial statements prepared in accordance with FIFO could well reflect profitability in such circumstances. In these and other situations, LIFO avoids the presentation of -- and, under the Internal Revenue Code, the taxation of -- "phantom profits," profits that are not actually experienced but that would appear on financial statements and tax returns if an issuer were denied the use of the LIFO method. The objective of avoiding that consequence remains as valid today as it was over 70 years ago when LIFO was first adopted as an acceptable accounting method for both financial reporting and tax purposes.

(2) <u>The Need to Avoid a Devastating Impact on the Economy</u> -- Because of the interaction discussed above between SEC decisions regarding acceptable accounting methods and the Conformity Requirement of the Internal Revenue Code, the SEC's adoption of IFRS accounting without a carve-out for the LIFO method could produce significant economic devastation. Such action by the SEC would force the very large numbers of U.S. issuers now using the LIFO method for both financial reporting and tax purposes into involuntary violations

of the Conformity Requirement. If the Treasury refuses to excuse such violations (which, as noted, the Treasury has the authority to do), these issuers not only would lose the tax benefits of LIFO accounting prospectively, but also would be forced to "recapture," or take into income, their LIFO "reserves" and thus be exposed to extraordinarily large tax payments to the Treasury Department in the immediate years ahead. Thus, in the midst of the current adverse economic circumstances the country is now experiencing, major new tax liabilities would be imposed on taxpayers using the LIFO method.

A brief explanation of the mechanics of the way the LIFO tax reserve is calculated may be helpful to an understanding of this point. As noted, under LIFO tax accounting, in periods of rising prices -- as have been generally experienced in most industries since LIFO was first accepted as a valid inventory accounting method -- some of the profits that would be taxable under FIFO are not taxable under LIFO. Since LIFO taxpayers are taxed based on the latest, rather than the earliest, costs of goods acquired or produced, cost-of-goods-sold deductions will typically be larger for a LIFO taxpayer than they would have been had the taxpayer been on FIFO.[7] The offsetting credit to that higher cost of goods sold is a reduction in the carrying value of the company's inventory. The LIFO reserve -- which is not an actual accumulation of company funds, but rather a figure the company is simply required to compute and record -- represents the difference between these two deduction amounts. The company is required to add each year to the reserve the difference between the amount of its cost-of-goods-sold deduction under LIFO and the amount of the deduction that would have been allowed to the company under FIFO. At any given time, therefore, the company's LIFO reserve is the cumulative

---

[7] A taxpayer's cost of goods sold as a technical matter is not actually a deduction from gross income but is rather an element of gross income that reduces the gross income amount before adjustments and deductions are applied to that amount. Treas. Reg. § 1.61-3. Since that cost operates in a manner similar to a deduction, however, and is often referred to in common parlance as a deduction, this comment will refer to it as such.

amount over the years of these "incremental deductions" permissible under LIFO, but not under FIFO.

A significant feature of the maintenance of the LIFO reserve is that it provides a mechanism for the "recapture" -- or the taking into income -- by the taxpayer of the amount of the reserve in certain defined circumstances. One of those circumstances is when the taxpayer changes its accounting method from LIFO to FIFO. When the reserve is taken into income, this has the effect of undoing, or retroactively restoring to income, the deductions that were responsible for the build-up of the LIFO reserve. The deductions that are restored to income are, as noted, the amount by which the deductions allowed the taxpayer under LIFO exceed those that would have been allowed under FIFO. Recapturing the LIFO reserve to income effectively puts the taxpayer in the same position as if the taxpayer had been on FIFO all along and had never reaped the tax benefits of LIFO accounting.

If LIFO taxpayers are forced to abandon the LIFO method because of the SEC's adoption of IFRS, the resulting recapture obligations will be extraordinarily large. Because the LIFO method has been authorized for tax purposes for over 70 years, many companies have accumulated very substantial reserves over time. In many cases these reserves are greater than the net worth of the company. The tax liability associated with taking those reserves into income, even over the four-year period that is typically provided by the Internal Revenue Service for reserve recapture, would severely harm large numbers of businesses and would render many of them insolvent. It is instructive that the current Administration's proposal to repeal LIFO for tax purposes has been scored as generating revenues of approximately $70 billion over 10 years.

The Coalition believes that the very large preponderance of those revenues would come from the recapture of current reserves.[8]

The harshness of this result is compounded by its retroactivity and its departure from taxpayer expectations. As noted, under the scenario that most concerns the Coalition, deductions that were taken as many as 60 to 70 years ago would be effectively repealed. The affected taxpayers took these deductions with the understanding that the extreme consequences of reserve recapture could be triggered by certain circumstances -- principal among these, a permanent reduction in the taxpayer's inventory levels. Taxpayers no doubt did not reflect, however, on the possibility that they would incur these consequences as a result of an SEC determination such as the one the Commission is now considering. Yet, that determination could now result in an abrupt termination of their businesses -- particularly in the case of thinly capitalized small businesses, many of which have long used LIFO as their inventory accounting method. Full-scale adoption of IFRS by the SEC, without more, would trigger these extremely unfortunate consequences. Alternatively, those consequences could be avoided entirely by a decision of the SEC to carve out the LIFO method from its action.

(3) <u>Appropriate Institutional Allocation of Responsibilities</u> -- A further reason for granting the Coalition's request is that it will take the SEC out of the difficult procedural circumstances it now faces. The SEC has never claimed that it is institutionally well-equipped to

---

[8] It is worth repeating that there *neither is nor ever was* any cash in a company's LIFO reserve. The tax savings the company received were invested back into the company to purchase replacement inventory, thus contributing to economic growth and job creation. With no actual cash in the reserve, repeal of LIFO would require affected companies to find or borrow the funds to pay the recapture tax. With 36% of U.S. companies using LIFO, the resulting huge demand for credit to pay recapture taxes would in many circumstances have a damaging impact on credit availability and interest rates. *See* Georgia Tech Financial Analysis Lab, *The Potential Consequences of the Elimination of LIFO as a Part of IFRS Convergence* 14 (Dec. 2008), *available at* http://www.savelifo.org/pdf-2011/GA%20Tech%20Study%20Consequences%20of%20the%20Elimination%20of%20LIFO.pdf. A seriously adverse macroeconomic impact could also be expected, since available credit resources would be tapped not to help create jobs and grow the economy, but to transfer funds in payment of retroactive taxes.

make tax policy decisions. The Conformity Requirement, however, has placed the SEC in a position where unless it grants the requested LIFO carve-out (or, once again, the Treasury Department decides to excuse Conformity Requirement violations), it will need to address very major tax policy matters in its consideration of whether to adopt IFRS accounting. It is hard to see how it could ignore such matters, given the substantial tax consequences that would necessarily result from its action. For this reason alone, it would be desirable to provide for the carve-out, thus leaving decisions regarding the acceptability of the LIFO method for tax purposes, the revenue needed to be raised in connection with LIFO repeal as against other potential sources of revenue, the adverse economic consequences associated with LIFO reserve recapture, etc. in the hands of Congress with the Treasury Department's assistance. There is probably general agreement that those entities are the ones best suited to resolve such tax policy considerations.

It can also be argued that the SEC is not well-suited to resolve the related trade policy considerations associated with LIFO repeal. Under the U.S. worldwide system of taxation, U.S.-based companies face both a high U.S. statutory tax rate and a tax on their foreign earnings when repatriated to the United States. It is well-established that these factors contribute to effective tax rates for U.S.-based companies operating worldwide that are among the highest in the world, and that this disparity in effective tax rates adversely affects U.S. competiveness.

One mitigating factor is LIFO tax treatment, which benefits U.S. companies and, unlike other tax advantages available to U.S. and foreign businesses, has never been subject to challenge by the WTO. If LIFO is repealed for tax purposes -- either by the Congress or indirectly by the SEC -- U.S. competitiveness can be expected to be damaged significantly. Once again, it is the Congress, rather than the SEC, that is in the best position to evaluate these international competitiveness considerations.

Conclusion -- Relevance to Current Congressional Debate

For these reasons, the Coalition requests the SEC, if it chooses to incorporate IFRS into the financial reporting system of U.S. issuers, to also provide for a carve-out from that decision that would allow such issuers continued use of the LIFO accounting method. The Coalition also urges that, if at all possible, the carve-out decision be made and communicated to the Congress quickly. That is in large part because views on the SEC's likely course of action on this subject are already influencing congressional consideration of pending legislative proposals to repeal LIFO for tax purposes.

Some in the Congress apparently believe that the SEC has made up its mind that IFRS will be adopted for U.S. issuers and that LIFO accounting will not be carved out from that decision. This view in turn is supporting the position among some Members that since these SEC decisions are essentially inevitable, Congress itself should repeal LIFO and thereby protect its ability to receive scoring credit for that decision -- credit that might be lost if Congress waits until after the SEC announces its final position. The Coalition is not representing that this position is widely held, but it has encountered the position in some congressional offices.

The Coalition believes this is an unfortunate development for two reasons. First, it detracts, at least to some extent, from congressional consideration of the actual merits of whether LIFO should be repealed for tax purposes. As discussed, Congress is better suited institutionally to assess that issue than the SEC, and it would be unfortunate if any Member of Congress failed to address its merits because of a belief that the SEC was destined to moot the issue. Second, these circumstances would be even more unfortunate if the perception of the SEC's mindset on these matters is inaccurate.

If the SEC is not prepared to make an expedited decision on IFRS and LIFO, therefore, the Coalition urges the Commission to communicate to appropriate Members of Congress that it has not in fact decided these issues and that Congress ought not to base its actions on the understanding that it has. Only then, we believe, will a potentially significant impediment to congressional consideration of the merits of LIFO repeal for tax purposes be removed. Without that impediment, Congress will then be able to address directly the tax policy issues associated the question of repeal. As noted, we believe those are issues that the Congress is best positioned to decide.