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Reply to Questions for the Record

Questions for the Record for:
Dr. George A. Plesko
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From Senator Grassley:

1. Doctor Plesko, you refer to data presented in “Treasury I” in your testimony. The Treasury I proposal included a recommendation that LIFO conformity be eliminated. Why shouldn’t that same recommendation hold now?

Treasury I was a comprehensive proposal with numerous inter-related recommendations. The repeal of LIFO conformity was part of general plan to index the entire tax system and was designed to ensure economic neutrality with respect to other newly indexed assets. As such, repealing LIFO conformity, without the other fundamental changes suggested in Treasury I, would only exacerbate any distortions created by LIFO.

2. Doctor Plesko, are there any guideposts or factors that you would recommend that we keep in mind with respect to book-tax conformity as we begin discussions about tax reform? That is, are there clear guidelines for when conformity or non-conformity is the right answer?

Let me reiterate that I do not agree that more book-tax conformity is always desirable. Tax and financial accounting serve related, but distinct, functions, and the measure of income for one cannot be assumed to be the appropriate measure for the other.

While questions of book-tax conformity have been around as long as the corporate income tax, there has been a renewed and growing focus on these issues in recent years. Conformity should not be an objective in and of itself, and certainly should not rise to the importance of other goals, such as efficiency. Conformity should be thought of as aiding the administration of the tax system, with the added feature of potentially reinforcing the incentives/disincentives provided by the tax code. I don’t think that we have yet reached a point where there is a consensus on the principles that should govern book-tax conformity, but there are some general questions to help guide policy.

First, would conformity aid in the administration of the tax law? Conformity should be considered when it can greatly reduce the tax and/or financial reporting compliance burdens of a business or facilitate the administration of the tax system, so long as the

conformity does not compromise Congress' intended goal of the tax provision or inhibit the transmission of important information to shareholders.

Second, does a lack of conformity generate opportunities for avoidance or manipulation? One advantage to conformity is that tax effects are also financial reporting effects, and tax minimizing behavior requires the reporting of lower profits. Therefore, in situations where Congress wants a firm's behavior to be most transparent, conformity should be considered. The disadvantage to conformity arises when the tax objective is at odds with the financial reporting objective. In cases when conformity is not desirable, improved disclosure to both the IRS and investors may be able to achieve many of the same objectives.

For additional information on book-tax conformity please refer to my previous testimony before this Committee on February 13, 2003 during hearings on *Enron: The Joint Committee on Taxation's Investigative Report* (S. Hrg. 108-117), and recent testimony by Professor Douglas Shackelford before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means , May 9, 2006.

From Senator Bunning:

1. In your discussion regarding the use of LIFO in corporate America, your written testimony cites numbers suggesting over 40% of large corporations use LIFO for some or all of their inventory accounting. Later, you assert that an analysis of the 5000 publicly traded companies with inventory shows only 8.7% of firms with inventories use LIFO. Could you explain the difference in these numbers?

Differences in the percentages are due to differences in the groups of firms analyzed. The "40% of large corporations" is based on an analysis of inventory choices of only the largest 600 publicly-traded corporations, as surveyed in *Accounting Trends & Techniques*. This is not a representative sample of all publicly-traded firms, as the same 600 firms are not analyzed in each year of the publication. For example, if several non-inventory firms were to become large enough to be in the sample, and they displaced the same number of firms using LIFO for their inventories, then it would (correctly) show the use of LIFO among the largest firms had declined, but, as stated in my testimony, "may not be representative of the corporate sector as a whole" (p. 4).

To better measure the extent of LIFO use I examined the inventory choices of all publicly-traded firms, and found the use of LIFO among firms with inventories to be substantially less than implied in *Accounting Trends & Techniques*. The 8.7% figure in my testimony was for 2004. Over the 1975 to 2004 period, the percentage peaked at 26% in 1980, and has steadily declined. As a result, the use of LIFO appears to be less prevalent than indicated by analyzing just the largest firms, and the use of LIFO appears to have declined regardless of what sample of firms are examined.

2. Your testimony implies that only about 5% of all companies use LIFO to account for their inventory. Treasury estimates that in 2003 there were more than 2 million C corporations, 3.2 million S corporations, and more than 2 million LLC's and partnerships. Assuming your estimate is correct, approximately 350,000 businesses would be adversely affected by the repeal of LIFO. Your analysis also suggests these businesses are concentrated in manufacturing, steel and chemical production, and retail. How would repeal of LIFO affect these businesses and industries?

The 5% figure was taken from *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President*, Volume 1, page 111 (November 1984), and the citation in my testimony inadvertently overstated the use of LIFO. In my testimony I stated that "Treasury's 1984 tax reform study ("Treasury I") reported that 95 percent of taxpayers use FIFO." (page 5). However, the Treasury I study reads, "Roughly 95 percent of firms *with inventories* use FIFO accounting for tax purposes." (page 111, emphasis added.) As a result, the 5 percent number cannot be multiplied by the 5.4 million corporate returns filed in 2003 to determine the number that use LIFO, but should be multiplied by the (smaller) number of firms *with inventories*. I do not think the number of corporate tax returns reporting inventories can be determined from the published IRS data, and therefore an estimate of the number of affected companies cannot be made with publicly-available data. However, the number of companies with inventories will be substantially smaller than the total number of companies.

Absent a more recent analysis of tax return data by the Joint Committee on Taxation or the Treasury Department, the Treasury I statistic of 5 percent is the most definitive estimate available. There is, however, evidence to suggest that the percentage will be lower, rather than higher, today. The percentage of publicly-traded firms that used LIFO for any portion of their inventories peaked in the early 1980s, and their use of LIFO is now only about one-third of those levels. It seems likely that the use of LIFO among privately-held firms would also have declined.

As for the sectors, the data presented in my testimony only represents the concentration of LIFO use among the 600 largest publicly-traded corporations as surveyed by *Accounting Trends & Techniques*. This may or may not be representative of the entire population of businesses, be they publicly-traded or privately-held, or whether they are corporations or pass through entities.

How LIFO repeal would affect any firm will depend on many firm-specific characteristics and the details of the specific provision, including what inventory methods would be permitted and the phase-in period. If LIFO repeal were an element of a tax reform proposal that both broadened the base and lowered the rate, the net effect on any firm will depend on the interrelationship of all of the provisions.

3. Your testimony notes that the LIFO reserves reported on the financial statements of publicly traded companies has declined since 1984 and now is around \$60 billion

dollars. The implication is that LIFO is less frequently used and that repealing LIFO would result in new tax revenues of around \$18 billion. Given that your estimate does not include the LIFO reserves of the vast majority of companies that are not publicly traded, isn't it likely that the actual tax increase incurred by hundreds of thousands of small and large businesses would be several times your estimate?

The \$18 billion figure cited in my testimony was not intended as a revenue estimate of any action the Committee might take, but merely to provide guidance about the magnitude of the cumulative amount of income deferred, and an idea of the tax revenue that might be generated, by changes to LIFO. First, as stated in my oral testimony, that figure was based on 2004 data, and I expect that the aggregate value of LIFO reserves has increased. Second, the data examined only publicly-traded firms, and, as your question points out, excluded privately-held entities. Third, there are other differences in how tax and financial accounting treat inventoried costs that would affect the estimate. Fourth, by looking only at the effect of taxing past deferrals the number explicitly ignored any future changes in the taxable income of firms no longer using LIFO.

However, were Congress to restrict or repeal the use of LIFO, the effect on revenue over the budget period would also be affected by the legislative language, which would likely mitigate some of the effects through transition rules. Among issues the language would likely address are: (1) the alternative methods of inventory accounting that would be permitted, and (2) the number of years allowed for firms to pay any liability.

The fact that the total number of companies using LIFO may be many times larger than the number of publicly-traded firms using LIFO does not imply that the revenue effects of changing LIFO would be many times the amount inferred from data available from publicly-traded firms. While there are a large number of businesses subject to the corporation income tax, aggregate economic activity is concentrated among the very largest firms.

IRS data for 2003 shows that 5.4 million corporate tax returns were filed, and that these businesses reported a total of \$53.6 trillion in assets. Of these 5.4 million returns, only 2,018 returns (0.0004 of the total, or four one-hundredths of a percent) reported assets in excess of \$2.5 billion, yet these same 2,018 returns reported more than 75 percent of all assets and were responsible for 67 percent of the total amount of net income (less deficit). If the size threshold is lowered to returns with at least \$100 million in assets, there were 20,477 returns filed (0.38 percent of the total), and they reported 93 percent of all corporate assets and 85 percent of net income (less deficit).

With respect to inventories, the 2,018 largest returns reported 34 percent of all inventories, and the 20,477 largest returns reported 60 percent of all inventories. But these percentages are likely understated because the balance sheets of firms using LIFO understate the value of inventory relative to other inventory methods (e.g., FIFO). As described above, the understatement is likely greatest among the largest, publicly-traded, firms.

Further, even among publicly-traded firms using LIFO, the effect of changes in LIFO will be concentrated among a relatively small number of firms. Based on 2004 financial statements, 50 percent of the total LIFO reserve is attributable to 15 companies, and 80 percent is attributable to 53 companies.

In short, as with many corporate tax changes, changes in revenue are likely concentrated among the largest, publicly-traded, firms.

4. Your written testimony indicates that LIFO reserves reported by publicly traded companies has declined since 1984. Is that trend necessarily due to a lower use of LIFO or could part of the decline be due to lower overall inventory levels in the U.S. due to increased use of just-in-time inventory management techniques?

Declines in the aggregate LIFO reserves can be caused by many factors, of which the decline in the use of LIFO documented above is only one. The textbook cited in my testimony provides a detailed description of how different factors may affect the interpretation of the LIFO reserve (L. Revsine, D.W. Collins, and W.B. Johnson, *Financial Reporting and Analysis*, 3rd edition, (Pearson Prentice Hall, 2004), chapter 9.)

Interestingly, recent research provides evidence that for some firms the adoption of just-in-time (JIT) inventory methods can be facilitated by the presence of LIFO reserves as increases in reported income resulting from LIFO liquidations offset the additional reported costs incurred in the same period to implement JIT. However, taxable firms with large LIFO reserves are found to be less likely to adopt JIT because of the tax consequences of LIFO liquidations. Further, the evidence suggests that firms with a history of managing their reported earnings were also less likely to adopt JIT. As a result, it appears that the adoption of new inventory management may actually be hampered by the use of LIFO. (M.R. Kinney and W.F. Wempe, "JIT Adoption: The Effects of LIFO Reserves and Financial Reporting and Tax Incentives," *Contemporary Accounting Research* 21:3 (Fall 2004) pp. 603 – 638.)

5. Your analysis of inventory manipulation is particularly interesting. For example, you assert that a company may purchase more inventory than it needs at the end of the tax year in order to reduce its tax obligation. Have there been real-world situations where you are aware of such inventory manipulation? How likely do you think such manipulation is in light of the incremental costs of purchasing and storing additional inventory to the business? If such manipulation did take place, what would be the resulting tax implications for the second tax year of this manipulation, when the company now has more inventory than it needs?

The incentives that LIFO provides for year-end purchasing is well-understood in the accounting literature and the results of academic studies are widely referenced or

summarized in textbooks. For example, D.E. Kieso, J.J. Weygandt, and T.D. Warfield, *Intermediate Accounting*, 11th Edition (Hoboken: Wiley, 2005) state:

Because of the liquidation problem, LIFO may cause poor buying habits. A company may simply purchase more goods and match these goods against revenue to ensure that the old costs are not charged to expense. Furthermore, the possibility always exists with LIFO that a company will attempt to manipulate its net income at the end of the year simply by altering its pattern of purchases. (page 393)

For firms to purchase additional inventory despite the incremental costs shows how significant the tax benefits can be, and further demonstrates the distortion in firm behavior LIFO can cause. Frankel and Trezevant (1994), for example, examine the year-end purchasing decisions of firms as a function of their inventory accounting methods and tax status and report (1) high-tax LIFO firms are more likely to purchase extra inventory at year-end than low-tax LIFO firms, (2) LIFO firms are more likely to purchase extra inventory than FIFO firms, and, by contrast, (3) FIFO firms do not show differences in purchasing that are related to their tax status. The authors conclude that their finding “that additional year-end LIFO inventory purchases appear to be made for tax reasons suggests that permitting the LIFO method to be used for tax purposes leads to inventory management inefficiencies.” (M. Frankel and R. Trezevant, “The Year-End LIFO Inventory Purchasing Decision: An Empirical Test,” *The Accounting Review* 69, No. 2. (April 1994), pp. 382-398.)

As for the “second year” effect” of such purchases, Frankel and Trezevant’s results suggest that if the firm remains in a high tax rate position inventory can continue to (inefficiently) build. Another alternative, described by Revsine, Collins, and Johnson in their textbook, shows how firms can use LIFO to manipulate multiple year’s earnings (both up and down) to meet targeted levels through year-end purchases or liquidations (L. Revsine, D.W. Collins, and W.B. Johnson, *Financial Reporting and Analysis*, 3rd edition, (Pearson Prentice Hall, 2004) pp. 469-470).

A comprehensive summary of research on the tax-motivated effects of LIFO can be found in D.A. Shackelford, and T. Shevlin, “Empirical tax research in accounting,” *Journal of Accounting and Economics* 31: 321-387 (2001).

6. Your testimony argues that the only reason a company would use LIFO is to reduce their tax liability. However, isn’t it true that companies have used LIFO to hedge against inflation? Absent the use of LIFO, how would you ensure the Federal Treasury does not profit from inflated nominal earnings resulting from inflation?

Companies have many ways to hedge against the possibility of increasing prices for inputs, such as through the use of futures contracts. Note that the primary reason a firm would want to do this is to reduce its cost of sales relative to what they would be in an unhedged position, exactly the opposite of the result that LIFO yields in calculating

earnings. LIFO is not a hedge in the traditional use of the term unless one explicitly acknowledges it as a tool to manage both tax liability and reported earnings.

The value of a business's inventory can go up for many reasons, not all of which can be generically attributed to inflation, yet LIFO can be used to reduce the tax liability of a firm regardless of the source of the change. As pointed out in Treasury I, there may well be strong arguments for mitigating the effects of inflation *throughout* the tax code, but to address inflation selectively leads to distortions in behavior. Interestingly, inflation does not appear to have been part of the original justification for the existence of LIFO, which at its inception was only narrowly permitted as a replacement for the base stock method disallowed in the 1920s. (A history and analysis of the development of inventory methods can be found in H.G. Barden, *The Accounting Basis of Inventory Accounting Research Study No. 13* (New York: AICPA) 1973.)

If the use of LIFO was primarily motivated by management rather than tax considerations, then we would expect LIFO to be an integral part of firms' operations, but this does not appear to be the case:

Many companies use LIFO for tax and external reporting purposes but maintain a FIFO, average cost, or standard cost system for internal reporting purposes. There are several reasons to do so: (1) Companies often base their pricing decisions on a FIFO, average, or standard cost assumption, rather than on a LIFO basis. (2) Record keeping on some other basis is easier because the LIFO assumption usually does not approximate the physical flow of the product. (3) Profit-sharing and other bonus arrangements are often not based on a LIFO inventory assumption. Finally, (4) the use of a pure LIFO system is troublesome for interim periods, for which estimates must be made of year-end quantities and prices. (Kieso, Weygandt, and Warfield *Intermediate Accounting*, 11th Edition, (Hoboken: Wiley, 2005), page 384).

Note in particular that if profit-sharing and management bonuses are not based on LIFO the implication is that the company does not consider LIFO to be a cost assumption appropriate in measuring a firm's performance.

If proponents of LIFO believe its use is necessary to ensure that income is properly reported, it seems they should advocate a requirement that *all* firms use LIFO for tax and financial accounting purposes, or, at a minimum, that an electing firm be required to use LIFO *exclusively*, rather than permit a business to use LIFO for a portion of inventories and another method (or methods) for their remaining inventory.

From Senator Baucus:

LIFO

1. Do you consider repeal of LIFO to be a tax increase? Explain.

In and of itself, repealing LIFO will increase revenues during the budget window. Over time, LIFO seems to have been intended to help mitigate the effects of changes in input prices. In practice, LIFO seems to have created a large indefinite deferral of income, in many cases resulting in a permanent rather than temporary loss of revenue. Unless the intent of LIFO is to allow businesses to permanently exclude inventory holding gains from taxation, the elimination of LIFO would only change the timing, not the overall amount, of revenue to be collected from these firms. If the use of LIFO has created an opportunity to permanently defer recognition of this income, then LIFO repeal will increase revenues relative to any baseline.

Given the tone of the hearing, it seems that the Committee is considering the possibility of numerous tax changes that would result in a more efficient tax system. At the heart of such a system, as discussed by Dr. Sullivan, is the goal of having a broader base and lower tax rates for all corporations. Any analysis of options to broaden the base of the corporate tax systems will need to examine the role of LIFO in greater detail.

2. You estimated that the LIFO reserve for the Fortune 600 companies is \$60 billion. What is your estimate of the cumulative LIFO reserve for all taxpayers, and the total amount of tax that is being deferred?

The \$60 billion figure is based on the LIFO reserve reported by all publicly-traded firms, not just the largest 600 firms.

It is difficult to estimate the full extent of LIFO usage without access to confidential tax return information. However, similar to other corporate tax changes, the preponderance of the revenue is likely to come from the largest, publicly-traded, firms. Please see my answer to Senator Bunning's Question 3.

3. What is the average number of years that a company defers taxes by using LIFO? Considering the time value of money, what is the present value of your estimate of the total amount of tax that is being deferred as a result of LIFO?

It is impossible to determine the number of years that a company has deferred taxes based upon their published information. As pointed out in my testimony, one of the reporting issues with LIFO is that inventory values on the balance sheet reflect "old" costs. Comparisons of a LIFO company to another LIFO company, or to a FIFO company, are difficult because companies may implement LIFO in different ways.

As I state in my reply to Question 3 from Senator Bunning, the \$18 billion figure cited in my testimony was not intended as a revenue estimate and ignores a number of factors. However, with respect to an estimate of the present value of deferral, the number would be larger than \$18 billion because I did not have data on privately-held firms, and I ignored all future benefits that firms would receive if LIFO continued into the future.

Given that LIFO may be creating a permanent, rather than temporary, deferral of income, knowing the average, and maximum, length of companies' reserves would help to inform the debate. If the average number of years is relatively short, then we could conclude that the benefits of LIFO are to smooth, rather than eliminate, tax liabilities. If the evidence shows the existence of very old LIFO layers then LIFO would be more accurately described as exempting, rather than just deferring, income from taxation.

4. What impact would the repeal of LIFO have on our nation's economy, competitiveness, employment levels and the financial markets?

The effect of LIFO repeal is hard to assess without knowing the specifics of what would replace it, especially if it were part of a comprehensive plan for base-broadening and rate reduction.

The relative effect of LIFO repeal for tax purposes depends not just on whether other countries allow it (some do) but also its particular implementation, and the extent of its use, in those countries. For example, if another country allows LIFO, but restricted it to situations where it matched physical flow, that country's experience would not be comparable to the U.S. If LIFO is, as financial data suggests, primarily a U.S. phenomenon, then it is difficult to imagine that U.S. firms that currently use LIFO would be at a disadvantage were they required to use the same accounting as their competitors. Further, as my reply to Senator Bunning's Question 6 points out, firms using LIFO do not appear to use LIFO costs for pricing or other businesses decisions, implying that the ability of a U.S. firm to compete is already independent of the availability of LIFO.

From a financial reporting perspective, we know that LIFO is generally a U.S. phenomenon and that at worst LIFO repeal would force U.S. companies to use the same financial accounting methods that companies in other countries use. Given that only a minority of publicly-traded firms with inventories appear to currently use LIFO for any portion of their inventories, it is difficult to imagine that there would be any significant effect on financial markets, especially since the LIFO conformity rule has been substantially weakened over time – a subject I address in Question 5, below.

Any inherent superiority LIFO may have over FIFO for financial reporting is also at odds with some firms' own disclosures. Consider the 2000 *Annual Report of The Goodyear Tire & Rubber Company*, which changed from LIFO to FIFO to *improve* its reporting:

During the fourth quarter of 2000, the Company changed its method of inventory costing from last-in first-out (LIFO) to first-in first-out (FIFO) for domestic inventories. Prior periods have been restated to reflect this change. The method was changed in part to achieve a better matching of revenues and expenses. The change increased net income in 2000 by \$44.4 million (\$.28 per basic and diluted share), and increased retained earnings for years prior to 1998 by \$218.2 million. (page 42)

Goodyear received a clean audit report from its auditor, PricewaterhouseCoopers, with the auditors appropriately noting that the change took place:

As discussed in Note 7 to the consolidated financial statements, the Company changed its method of accounting for domestic inventories in 2000. (Page 61).

5. To what extent do you believe there is a benefit in the book/tax LIFO conformity rule? Since companies can use different LIFO “submethods” for book and tax, resulting in different LIFO reserve amounts for book and for tax, does the conformity rule serve its intended purpose?

The phrase “LIFO conformity” is a general one that implies (or assumes for simplicity) that inventory accounting is identical for tax and financial reporting purposes if a firm elects LIFO. This is an oversimplification, and observers suggest that firms are able to take advantage of LIFO for tax purposes without having to report LIFO costs to shareholders.

In an April 13, 2001 letter to Secretary Paul H. O’Neill, Edmund Jenkins, then serving on the Financial Accounting Standards Board, argued for repealing LIFO conformity because conformity was not, in practice, taking place. Specifically, Mr. Jenkins stated

The level of conformity that is in fact achieved may well be illusory. The background section of Accounting Series Release (ASR 293) reports the following:

"On January 13, 1981, the IRS published amended regulations² concerning the LIFO conformity rule. For many years, the IRS strictly enforced the conformity rule and required companies to apply LIFO in most cases identically for books and tax purposes and did not permit companies to disclose supplemental information about alternative methods of inventory pricing.³ The Commission considers two aspects of the IRS amendments to be significant: (1) companies may apply LIFO differently for book purposes than for tax purposes as long as they use an acceptable form of LIFO; and (2) companies may provide supplemental non-LIFO disclosures if they are not presented on the face of the income statement."

² Treasury Decision 7756, Title 26 CFR 1.472.2(e).

³ There have be exceptions to this rule, e.g. the IRS issued annual waivers to permit companies in [*sic*] comply with ASR 190, involving replacement cost, without violating the conformity rule.

Source: Tax Notes Today (2001 TNT 86-34).

Mr. Jenkins further argued that the existence of the rule was “an impediment to improving international accounting standards.”

6. The International Accounting Standards Board (IASB) has proposed prohibiting the LIFO method of accounting for inventory. The U.S. Financial Accounting Standards Board (FASB) has entered into a Memorandum of Understanding with the IASB with the intention of achieving international convergence. To what extent should the tax code comport with accounting standards that prohibit LIFO? To what extent should other ideas from financial accounting be imported to the tax law?

Tax and financial accounting rules serve different, but related, purposes. Some level of conformity, even if it is only conceptual, will reduce the administrative and compliance burdens of the two systems. Regarding LIFO, the tax system seems to encourage financial reporting that is different from what firms would otherwise choose. To the extent that the conformity requirement is not binding, LIFO provides only a tax benefit that evidence suggests may interfere with other business decisions.

As for the broader question of book-tax conformity, please see my response to Senator Grassley's Question 2.

7. To what extent do existing LIFO methods accurately isolate cost increases due to inflation compared to other factors, including inventory mix, definition of an item, transportation costs, and productivity? How could LIFO be revised so that factors other than inflation are not included in the reserve? Would these revisions require legislative changes or could they be done administratively?

Isolating the effects of inflation from other sources of price changes is always difficult, and incorporating such adjustments into the tax code adds complexity. The use of "dollar-value LIFO," which further separates LIFO costs from physical flows by allowing the pooling of different items into a single LIFO pool, makes it even more difficult to isolate inflation from other factors that increase the value of inventories.

As part of its goal to address indexing throughout the tax code, Treasury I proposed firms be given the option to use indexed FIFO, which would adjust for the effect of inflation on the value of inventory since it was acquired, while removing the ability to manage reported earnings through end of year purchases / liquidations.

8. Do you think taxpayers generally calculate LIFO inventory accurately? What are the most frequent factors of noncompliance?

See answer to question 9 below.

9. Do you think the IRS does a good job of enforcing LIFO? Do you think IRS guidance accurately applies the law?

With respect to Questions 8 and 9, I have no basis to suggest that taxpayers are unable to effectively comply with the LIFO regulations, nor can I comment on the IRS's enforcement efforts. However, as the IRS has worked to make compliance with the LIFO rules easier it appears to have also created opportunities for more inventory gains to be permanently deferred, and compromised the original intent of the book-tax conformity requirement.

Further, the lack of substantial numbers of IRS challenges to current LIFO practices is separate from the issue of whether firms are able to manipulate their reported income through the use of LIFO. The academic evidence is clear that LIFO is a mechanism used by firms to manage both their financial and tax reporting results.

10. What is your opinion of the IRS “cut-off” method for voluntary changes in LIFO? Is it fair to allow taxpayers who stop using LIFO to avoid paying taxes on their LIFO deferrals when other taxpayers have paid taxes all along on their income?

The fundamental problem with allowing any recognition of LIFO deferrals without subjecting them to tax is that it converts what should be a deferral to an exemption. While I cannot directly attest to “fairness,” allowing selective exemption from taxation clearly violates principles of horizontal equity.

11. Do you consider the “definition of an item” to be a FIFO or a LIFO issue?

The “definition of an item” is a legal issue beyond the scope of my testimony. However, I will note that the need to define an item is necessitated by inventory accounting rules that separate cost flows from physical flows, and therefore a more important issue under LIFO.

PUBLIC DISCLOSURE OF TAX RETURN INFORMATION

1. Do you think the tax return information of companies who are not required to file Schedule M-3 should be public? If so, please explain what forms and schedules should be released, and why.

I do not think that the case has been made that the complete tax return of any company, regardless of whether it files an M-3, should be made public. Further, there is a distinction between requiring disclosures from public companies, which are already required to provide substantial information through regulatory filings, and private companies, which generally have no such requirement. The case for better disclosure of tax information, at this point at least, relates to public companies.

2. How do you respond to concerns about protecting a company's confidentiality if tax return information is disclosed?

Confidentiality of taxpayer information, even of publicly-traded firms, is an important factor when considering additional disclosures. Unrestricted disclosure has the potential of both revealing confidential information to competitors and may jeopardize or complicate our system of voluntary compliance.

However, with respect to public companies, financial reporting already requires disclosure of many aspects of a firm's operations, including various tax attributes. Empirical evidence, as well as the observations of financial market practitioners, suggests that current disclosures are often inadequate in providing the intended information, and make the inference of tax attributes difficult, if not impossible, for users of financial statements.

In this regard, the Schedule M-3 is unique. In the absence of new financial reporting requirements the release of the Schedule M-3, or a version of the Schedule M-3 consolidated to match the published financial statements, would seem to provide the same type of information that current financial accounting rules require, but supply it in a format and level of detail that would be of greater use to investors.

3. What impact would the disclosure of tax return information have on the foreign and domestic competitive position of US companies?

As stated above, unrestricted disclosure of tax return information has the potential to reveal important confidential information to competitors, either domestic or foreign. The exact effect on U.S. companies is difficult to estimate, but in the absence of compelling evidence that the disclosures are both necessary, and cannot be met through less invasive means (such as the Schedule M-3 and / or better financial statement disclosures) disclosure is not warranted.

However, it should also be noted that foreign companies that file their financial statements in countries that have greater book-tax conformity than the U.S already provide greater information about their tax attributes than do U.S. firms.