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Improvements project - planned elimination of LIFO method in IAS 2

Ladies and Gentlemen,

In May this year the International Accounting Standards Board (IASB) submitted proposals for revision of International Accounting Standards (IAS) and invited comments. Under these proposals use of the last-in-first-out (LIFO) method for simplified cost calculation in IAS 2 would no longer be permissible with effect from 1 January 2003 for two reasons: first, it is claimed that the information value of annual accounts drawn up using this method is distorted in essential elements; and second, that the tax advantages arising from this method should not be incorporated in annual accounts based on IAS.

The central organisations representing German business sectors fundamentally recognise efforts to bring accounting standards more closely into line, with a view to creating efficient and transparent capital markets and increasing the information value and comparability of annual accounts. However, we consider that this objective has not been achieved in the planned revision of IAS, in particular with regard to IAS 2. We take this opportunity to set out our position.

The central organisations representing German business sectors endorse the objective of eliminating inconsistencies and overlaps through ongoing improvement of applicable standards. In line with that objective, we are in favour of retention of the LIFO method as a cost formula into the future. We resolutely reject deletion without replacement from IAS 2 of the LIFO method as a reliable cost formula. We believe that the considerations on elimination of the LIFO method are insufficiently underpinned. In more detail, we have concerns about the following aspects:

- Elimination of the LIFO method can lead to considerable **narrowing of insight into the profit situation** in businesses which hold stocks with a sharply fluctuating value. Given that under the LIFO method assets are consumed and sold at the most recent, i.e. almost contemporaneous, prices, this cost formula gives a particularly good insight into the profit situation. As such, it provides better information than, for instance, average cost, while at the same time ensuring comparability of results with other years. Elimination of the LIFO method would clearly pose a risk for the IAS principle that accounts should give a true and fair view of the asset, financial and profit situation. We accept that hidden reserves are created under the LIFO method in periods of rising prices, due to the requirement to use the higher valuation. The objection that this could distort a proper insight into the asset situation is clearly countered by the additional disclosure obligations in accordance with IAS 2.36. Under this provision, the LIFO reserve has to be disclosed, in principle regardless of the size of the difference. Additional disclosures may be required if the LIFO reserve is eliminated to a large extent during the year due to large scale de-stocking and this influence is material for assessment of the profit situation. Moreover, annual accounts drawn up in accordance with IAS must comprise, in the balance sheet or an appendix, a description of the methods used for stock valuation including the underlying cost allocation procedure. Accordingly, insight into the asset situation, supposedly distorted due to use of the LIFO method, actually tends to be enhanced thanks to the additional disclosure requirements. We therefore continue to regard LIFO as a method that should be given preference.

- With elimination of the LIFO method, the different regimes permissible at national level would diverge even more sharply. Under the present regimes, the separate value assessment carried out for each asset (principle of item-by-item valuation) is the basis for valuation. However, because item-by-item valuation of assets is not always possible or only at disproportionately high cost, national and international accounting rules leave discretion for a wide range of ways to simplify valuation. These include valuation at average prices, consumption sequence procedure, valuation based on standard values and quantities and all-in valuation. With the exception of valuation based on standard values and quantities, these procedures are permissible as valuation methods not only under IAS but also under US-GAAP and German commercial law (HGB), in particular in conjunction with the FIFO method and the LIFO method. Hence, elimination of the LIFO cost formula in IAS would lead not to an approximation of standards but to increasing divergence between IAS and US-GAAP. IASB should not create any new point of conflict which could impede the desired recognition of IAS by the SEC.

The planned elimination of the LIFO method unacceptably assumes that replacement prices for assets valued under the LIFO method continuously increase. Yet, this does not reflect the reality. Fluctuations and sometimes declines in replacement costs are also observed for assets valued under the LIFO method. Valuations reached under the LIFO method are also subject to the lowest value principle applicable in both national and international accounting regimes, so that the value ascertained under the LIFO principle cannot be applied if the value is lower on the date of the accounts. This means that higher valuations are not permissible. The lowest cost principle generally comes into play precisely when replacement costs fluctuate or fall. Hence, the assertion that the simplified LIFO cost formula leads to a distorted view of the real value does not stand up to examination.

Grouping of a large number of similar assets facilitates and simplifies the valuation procedure, as it also does for the LIFO method. The simplification procedure in Germany proscribes reporting which goes beyond certain limits, whereby proportionality must be maintained in valuations. However, valuation under the LIFO method is linked to certain conditions. In this regard, it is ruled out that assets can be valued on a generalised basis under the LIFO method. The decisive factor is that the consumption sequence does not diverge completely from the actual sequence of events. Yet, in many cases, valuation under the LIFO method does indeed follow the actual consumption sequence, as is often the case for valuation of wine, coffee, tobacco, timber or metals. It is precisely in these cases that item-by-item valuation does not make sense, due to the similarities between the goods. The LIFO method is often used in such cases, when this corresponds to the actual sequence of events. Thus, elimination of the LIFO method would in these cases result in a more complicated procedure yet not produce a better valuation of assets. This would not enhance the information value of the accounts, it could even cause further distortions.

Approximation of accounting standards cannot be regarded in complete isolation from **tax implications**. With a view to national regimes, in Germany as in other states, the commercial accounts are a decisive element for determination of the tax accounts. For that reason, amendments to IAS can have serious tax consequences. Under German law, the LIFO method can be used for valuation of assets for tax purposes if the LIFO method is also used in the commercial accounts (5 paragraph 1 sentence 2 EStG). As long as the commercial accounts are decisive for the tax accounts under national law in Germany, the LIFO procedure must be maintained as a legal option for businesses choosing a valuation method. While the idea that tax aspects should not influence IAS is understandable, thought must nevertheless be given to the negative implications in individual cases. It was precisely because of financial consequences likely to threaten the viability of businesses that the LIFO method was recognised for tax purposes in Germany. Otherwise, companies would have faced considerable financial difficulties due to enormous tax payments not matched by realised profits. The associated book losses because of lower costs would not have brought any comfort since they would have only resulted in a loss with no direct effect on liquidity. In addition, it is only possible to carry losses forward to a limited extent.

Without the LIFO method, bank financing of companies would become considerably more difficult due to sharp balance sheet fluctuations.

The LIFO method in itself does not warrant any tax advantage - as pointed out in the considerations on the planned elimination - but is justified primarily by the avoidance of reporting and taxation of fictitious profits, alongside the objective of simpler valuation. **Avoidance of reporting of fictitious profits** is necessary not only for tax purposes but also in particular from the angle of drawing up transparent accounts which reflect reality for publication purposes. In the interests of investor protection, reporting of fictitious profits is to be avoided - as substantiated in Germany by the objective of § 256 HGB. Reporting excessively high values which lead to “profits” which do not really exist is not in the interests of investors. For instance, the price of many metals is determined on world markets and is subject to considerable fluctuations. These markets are characterised by speculative price increases which are often unsustainable and then collapse. Thanks to the LIFO method, it is possible to avoid reporting enormous fictitious profits on the one hand and the subsequent fictitious losses, thereby making it possible to give a fair view not only of the profit situation but also of the asset situation, in the interests of investors.

The LIFO method is an economically sensible and necessary method for simplifying valuation where there is a tendency towards price fluctuations and a timing difference between purchase and sale of assets, whereby the profits generated are purely on paper yet are essential in order to replace the assets. Without the LIFO method, price increases in particular undermine the substance of businesses which need to hold considerable assets in order to be prepared to carry on business, especially in trade and industry. In addition, the LIFO method should be a permissible alternative valuation model in order to smooth out sharp fluctuations in results caused exclusively by price fluctuations on world markets, and in order to balance cumulative annual price increases.

An international comparison of the acceptability of the LIFO method as an alternative valuation method reveals that it is permissible not only in the USA but also in many Member States of the European Union. For instance, the LIFO method is applicable in at least Austria, Belgium, Germany, Greece, Great Britain, Italy, Luxembourg, Portugal and Spain. This is yet another reason to stand back from elimination of the LIFO method.

In particular, we would once more like to draw attention to the USA where the LIFO method has long been permissible for both commercial and tax purposes. IASB should make every effort to avoid creating any new point of conflict which could further impede recognition of IAS by the SEC.

For the future, the central organisations representing German business sectors urgently call to be involved directly in the opinion-forming process for planned amendment of International Accounting Standards, with amendment proposals being circulated directly to them for opinion. Simple posting of proposals for downloading from the Internet does not do justice to what is needed in the light of the importance of accounting standards for the preparation of annual accounts.

Yours sincerely,

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