ACCOUNTING WITH ‘LIFO’ VS. ‘FIFO’:

THE DEVIL IS IN THE DETAILS

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The ongoing collaboration between the International Financial Reporting Standards (IFRS) and Federal Accounting Standards Board (FASB) has tax-related implications for medical group practices. One of the goals of this collaboration — harmonization of accounting standards across countries — has been pursued since post-World War II economic integration.[1] Generally accepted accounting principle (GAAP) negotiations involve increased global transparency and similarity of accounting standards.[2,3]

To accomplish their goals, IFRS and FASB have proposed changes that would require significant financial statement evaluation and interpretation from healthcare organizations during a time of ongoing reform initiatives, such as pay-for-performance requirements and payment reductions.

One of the IFRS/FASB proposals is to move from a last-in, first-out (LIFO) costing method to a first-in, first-out (FIFO) method for all inventory and supply items. Practice administrators whose healthcare organizations use a LIFO costing method should seek guidance from a healthcare accountant as IFRS/FASB collaborations continue. A policy change to GAAP could significantly alter the financial accounting practices for group practices and have a direct effect on balance sheets and statements of operations.

Implications

Moving from a LIFO to a FIFO costing method has more implications for independent physician groups because of practice acquisitions, mergers and other unique hospital network assimilation efforts that require integrative changes to practice inventory control and a representation of assets on balance sheets. The proposal to eliminate the use of current LIFO inventory costing would have the following effects on healthcare organization financial statements:

- The cost and time required to transition from LIFO to FIFO inventory costing systems
- Significant revaluation of assets on the balance sheet (last-in, still here vs. first-in, still here)
- A potential tax liability for a for-profit organization transitioning from a LIFO costing system resulting from a higher profit margin and therefore incurring a greater tax liability while transitioning to the FIFO costing method

A simple method comparison is illustrated in Figure 1.

Figure 1. Inventory costing methods and the effect on expense and inventory (asset) values

Item purchased for $10 on Jan. 1, 2014	Used (sold) on July 1, 2014	Purchased an additional inventory item for $15 on Dec. 1, 2014
July 1, 2014 FIFO: $10 expense results in a $15 ending inventory balance on Dec. 31, 2014.		
July 1, 2014 LIFO: $15 expense results in a $10 ending inventory balance on Dec. 31, 2014.		
Note: Assuming a perpetual (ongoing) LIFO vs. FIFO inventory costing method throughout 2014.		

Rejection of the LIFO costing method

If FASB adopts current IFRS practices and the LIFO inventory costing method used by medical groups is changed, there could be serious implications for groups, including the potential for significant tax liabilities.[4]

In times of ever-increasing (inflation) costs of medical supplies, durable medical equipment (DME) and other medical goods valued at historical cost (purchase price) are to be listed on the organization's balance sheet as assets (supply/inventory) until used in the course of patient care. When supplies are pulled from the shelf for use, the practice of using the FIFO method of inventory costing will capture the supply expense at the lower historical cost (earlier purchase date) versus a LIFO method used to value the supply expense (more recent purchase date). As a result, the cost of goods used in patient care operations based on the LIFO method (higher historical value and usage expense) affects the profit margin on the statement of operations when compared with the FIFO costing method.

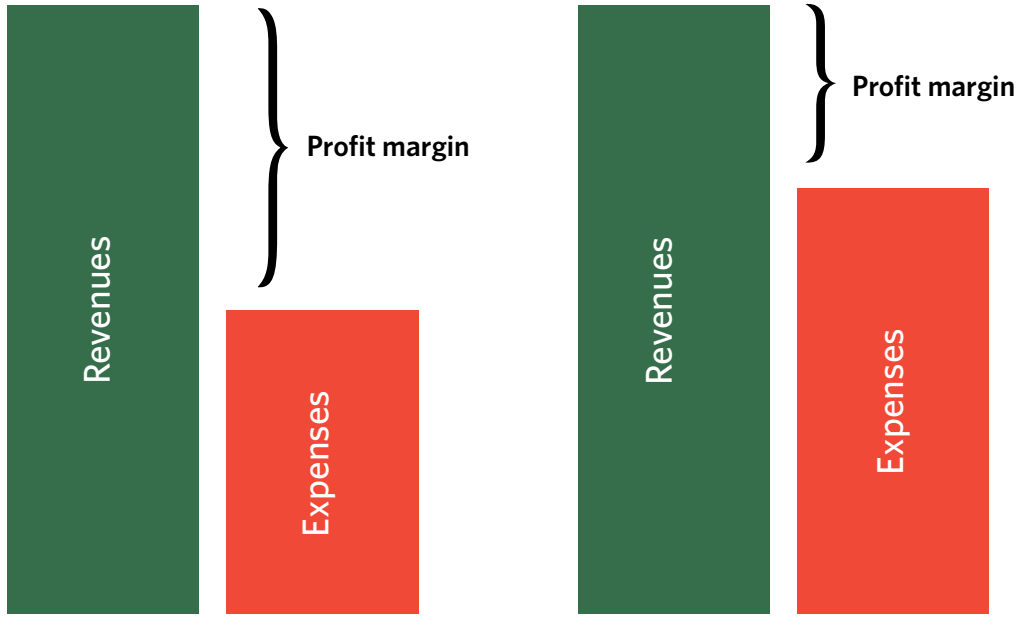
When a medical organization uses inventory that is time-sensitive (for example, medications with expiration dates), the FIFO inventory costing method is helpful. In other words, you pull the oldest viable item for use in patient care delivery, which leaves the most recently purchased inventory on a practice shelf (and valued as assets on a balance sheet). If current market conditions continue to involve price inflation, items left on the shelf will be valued at a higher historical (purchase) price than older items pulled for use in patient care. This enables the organization's balance sheet inventory assets to be reported at higher, more recently purchased prices while the older, earlier purchased and lower priced items have been used in patient care services.

LIFO statement of operations benefits (tax shield)

Regardless of an organization's for-profit or not-for-profit status, the primary benefit of using a LIFO inventory costing method during times of inflation involves the profit margin for the year. Assuming that a higher tax rate will be applied to for-profit organizations with higher profit margins, the LIFO inventory costing method allows these organizations to report higher inventory expense, as outlined in Figure 2.

As a result, the organization using a LIFO inventory costing method generates and reports higher inventory

Figure 2. Inventory FIFO/LIFO costing methods and the effect on organizational profit



expenses for the financial period. In a for-profit practice, this tax shield translates to a lower tax rate since the organization's profit margin is reduced. Such reporting benefit does not only apply to for-profits though. Consider a not-for-profit facility that is simply reimbursed for medical services (including supplies) at cost. If a higher cost of supplies is reported under this contractual arrangement, the not-for-profit organization will experience higher patient service revenue related to these patient encounters (reporting the higher cost, more recently purchased items used in patient care). ■

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Notes:

1. "Comparability in International Accounting Standards — A Brief History." Financial Accounting Standards Board. 2015. Retrieved on Feb. 1, 2015, from: mgma.org/comparability-IASB.
2. "— An Overview." Financial Accounting Standards Board. 2014. Retrieved on Oct. 29, 2014, from: mgma.org/FASB-overview.
3. "Convergence between IFRSs and US GAAP." International Financial Reporting Standards. 2014. Retrieved on Oct. 29, 2014, from: mgma.org/IFRS-GAAP-convergence.
4. International Financial Reporting Standards (IFRS): An AICPA Backgrounder. American Institute of Certified Public Accountants. 2011. Retrieved Nov. 12, 2014, from: ifrs.com/pdf/IFRSUpdate_V8.pdf.