

## Teaching Notes for Financial Accounting

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### ***Ethics Question 2***

#### During coverage of inventory

What criteria can be used to guide the decision about the appropriate inventory valuation method to employ? Are there conflicting interests at play during this decision? Who interests should take priority?

Inventory valuation is another area within accounting where management has discretion. Considering the motivations of management can lead this discussion in numerous directions. Below are some thoughts that can be incorporated into class discussion. (Taken from Haen, 2013. "Integrating Catholic Social Teaching into Undergraduate Accounting Courses" *Journal of Catholic Higher Education*, 32, 1, 93-95).

So how should a company decide which method should be used? The technical answer is to select the cost flow assumption which most accurately reports periodic income. Also, in most cases in the United States, if a corporation uses LIFO for income tax purposes it must also use LIFO for external reporting purposes. In most textbooks the discussion of the appropriate inventory valuation method stops here, and students complete homework assignments based on whatever method they are told to use.

There is an opportunity here to expand the discussion through the use of CST principles. As noted previously, transparency is a necessary consideration when applying CST to accounting decisions.<sup>1</sup> So how should a future accountant decide what is more important, a transparent balance sheet (use FIFO) or a transparent income statement (use LIFO)? An answer that covers all scenarios is impossible to develop, but it is an excellent opportunity for students to consider some of the decision points in accounting from a CST perspective without necessarily coming to the one correct answer.

For example, profit-sharing plans many times use net income as a factor when determining the amount that will be contributed by the company.<sup>2</sup> In a period of rising costs, LIFO will report the lowest net income and could potentially result in the lowest contribution by the company. Thus, does the use of LIFO violate the CST component of *The Dignity of Work and the Rights of Workers*, since workers are not receiving their just wage? However, if FIFO is used, net income will be higher and thus the contribution to the profit-sharing plan is increased, although this can be seen as detrimental to the stockholders, since the value that remains in the company goes down. How are decisions

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<sup>1</sup> Bridget Lyons and Lucjan T. Orlowski, "Transparency in Financial Markets and Institutions: A Catholic Social Thought Perspective": 3, accessed June 27, 2011,  
<http://www.sthomas.edu/cathstudies/cst/conferences/thegoodcompany/Finalpapers/Lyons%20and%20Orlowski%20f.pdf>.

<sup>2</sup> Of course the inventory valuation method used to calculate net income for profit-sharing plan purposes may be a negotiated part of a union contract so management may not have the discretion described here, but it still can be used an example that many students will understand.

made when the interests of various groups appear to contradict one another? In some cases other CST principles such as the *Option for the Poor and Vulnerable*, can further refine the decision-making process. For example, hold a discussion on the question, “Who are the poor? Who will be most affected by the accounting decision, the worker making \$10 per hour or the elderly woman depending on a steady return from her retirement savings invested in the company?

Additionally, since net income is lower, LIFO will result in the lowest amount of income taxes. Can the use of LIFO be seen as violating the CST component of *Rights and Responsibilities*, since the company will pay fewer taxes in relation to its peers who do not use LIFO? Of course, most stockholders want the company to pay the smallest amount of taxes that it legally can, since it allows more wealth to be retained by the company and possibly later distributed to stockholders. From this perspective, CST becomes a tool to help students better understand the complexity of decisions that businesses have to make in light of competing interests.