Accounting 402
Illustration of a change in inventory method

The Frank-Lex Company was incorporated in January, 20X5. At the beginning of 20X7, the company decided to change to the FIFO method. Frank-Lex had used the LIFO method for financial and tax reporting since its inception but has maintained records that are adequate to determine the results had the FIFO method been applied in all years. The following was determined from those records: (assume a tax rate of 40% in all years)

Date	inventory determined by	
	LIFO method	FIFO Method
01/01/20X5	0	0
12/31/20X5	55,000	80,000
12/31/20X6	160,000	180,000
12/31/20X7	240,000	270,000

Original Income statements for 20X6 and year 20X5 (using LIFO):

Frank-Lex Company
Income Statement
for the Year Ended December 31,

	20X6	20X5
Sales	**$ 560,000**	**$ 510,000**
Cost of sales:		
Beginning inventory	55,000	0
Purchases	500,000	**460,000**
Goods available for sale	555,000	460,000
Ending inventory	160,000	**55,000**
Cost of goods sold	395,000	**405,000**
Gross profit	165,000	105,000
Selling, General & administrative expenses	48,000	**44,000**
Income before tax	117,000	61,000
Income taxes	46,800	**24,400**
Net income	$ 70,200	$ 36,600

Accounting 402
Illustration of a change in inventory method

What kind of change is involved? Discuss and illustrate how this change in accounting would be reported.

Step one: Determine the cumulative effect of the change in inventory as of January 1, 20X7:

year	LIFO	FIFO	effect on income Difference

Step two: Determine the tax effect of the change

Step three: Prepare the journal entry(ies) to effect the change:

Date	ACCOUNT	DR	CR
01/01/20X7			
	To record the effect of a change in accounting principle		

Accounting 402
Illustration of a change in inventory method

Partial Comparative Income statement for 20X7:

Frank-Lex Company
Comparative Income Statement-FIFO
for the Years Ended December 31,

	20X7	20X6 (restated)	20X5 (restated)
Sales	$ 800,000	$ 560,000	$ 510,000
Cost of sales:			
Beginning inventory			
Purchases	660,000	500,000	460,000
Goods available for sale			
Ending inventory			
Cost of goods sold			
Gross profit			
Selling, General & administrative expenses	60,000	48,000	44,000
Income before tax			
Income taxes			
Net income			

Accounting 402
Illustration of a change in inventory method

Retained earnings statement for 20X7:

Frank-Lex Company
Retained Earnings Statement
for the Years Ended December 31,

	20X7
Beginning Retained Earnings	
Change in Accounting Principle	
Beginning retained earnings–adjusted	
Add: Net income	
Ending Retained Earnings	

Comparative Retained earnings statement for 20X7 and 20X6:

Frank-Lex Company
Retained Earnings Statement
for the Years Ended December 31,

	20X7	20X6
Beginning Retained Earnings		
Change in Accounting Principle-net of tax effect		
Beginning retained earnings–adjusted		
Add: Net income		
Ending Retained Earnings		

Comparative Retained earnings statement for 20X7, 20X6 and 20X5:

Frank-Lex Company
Retained Earnings Statement
for the Years Ended December 31,

	20X7	20X6 restated	20X5 restated
Beginning retained earnings–adjusted			
Add: Net income			
Ending Retained Earnings			

Accounting 402
Illustration of a change in inventory method

The Company has already prepared its financial statements for 20X7, and the income statements for 20X7, 20X6, and 20X5 are presented below:

Frank-Lex Company
Comparative Income Statement–LIFO Basis
for the Years Ended December 31,

	20X7	20X6	20X5
Sales	$ 800,000	$ 560,000	$ 510,000
Cost of sales:			
Beginning inventory	160,000	55,000	0
Purchases	660,000	500,000	460,000
Goods available for sale	820,000	555,000	460,000
Ending inventory	240,000	160,000	55,000
Cost of goods sold	580,000	395,000	405,000
Gross profit	220,000	165,000	105,000
Selling, General & administrative expenses	60,000	48,000	44,000
Income before tax	160,000	117,000	61,000
Income taxes	64,000	46,800	24,400
Net income	$ 96,000	$ 70,200	$ 36,600

Accounting 402
Illustration of a change in inventory method

What kind of change is involved? Discuss and illustrate how this change in accounting would be reported.

Step one: Determine the cumulative effect of the change in inventory as of January 1, 20X7:

YEAR	LIFO	FIFO	effect on income Difference
Inventory– 12/31/20X6	160,000	180,000	(20,000)

Step two: Determine the tax effect of the change

40% times $20,000 = $8,000

Step three: Prepare the journal entry(ies) to effect the change:

Since the Company has already prepared its income statement using the old (LIFO) method, the adjusting entry has to include a correction of the ending inventory, not the beginning inventory.

Date	ACCOUNT	DR	CR
	To adjust the ending inventory of 20X7 to FIFO basis		
	To record the effect of a change in accounting principle		