Example of LCM With Floor Ceiling Limitations

The XYZ Company has one unit of inventory on hand at 12/31/X1. During the period, there was a total of 2 units on hand that had been purchased at an acquisition cost of $60 each. In each case below, you are to determine the effect upon profits both in the current period and the following period if (1) LCM is applied without consideration of the AICPA's floor and ceiling limits and (2) with consideration of these limits in determining ending inventory values.

Case A (resulting in a ceiling limitation)

Assume anticipated sales price of $59 next period for this one unit; sales price has been $67 this period. The replacement cost is $57, costs to sell is $3, normal profit $4 per unit.

Case B (resulting in a floor limitation)

Assume all facts in Case A, with the exception of anticipated sales price which is not $65.

(See attached statements)

Summary Points on LCM

1. Using LCM assumes a decline in selling prices when a decline in replacement (or reproduction) cost occurs.

2. Floor-ceiling limits are imposed in order to keep the current period from either benefiting or being "penalized" at the "expense" or benefit of a future period when the inventory item is sold.

3. If the application of LCM results in using a ceiling valuation for an inventory item, then the resulting profit in the period of subsequent sale is always going to be zero. Likewise, if a floor valuation results, the profit in the period of sales of that item will be limited to the normal profit previously realized. (Assuming of course, that anticipated sales price is realized and selling expenses are as estimated).

XYZ Company
Comparative Income Statements Using Cost, LCM with and without Floor-Ceiling Limits

Case A (ceiling limitations resulting)

| | Period Ending 12/31/X1 | | | Period Ending 12/31/X2 | | |
| | | LCM | | | LCM | |
	Cost	Without Limits	With Limits	Cost	Without Limits	With Limits
Sales..........	$ 67	$ 67	$ 67	$ 59	$ 59	$ 59
Cost of Sales:						
Goods available	120	120	120			
Less Ending Inventory.....	60	57[1]	56[2]			
Cost of Sales.	$ 60	$ 63	$ 64	$ 60	$ 57[3]	$ 56[3]
Gross Margin....	7	4	3	(1)	2	3
Selling Expenses	3	3	3	3	3	3
Net Income (loss)	$ 4	$ 1	$ 0	$ (4)	$ (1)	$ 0

Notes: 1)   Valued at replacement cost.

2)   Valued at ceiling-i.e., $59 (anticipated sales price)- $3 (cost to sell = $56. Floor would be $56 (ceiling) - $4 (normal profit) = $52. Since replacement cost is above ceiling we are limited to the ceiling under the AICPA ruling.

3)   Cost of Sales, 2nd period, is equal to Ending Inventory, 1st period.

Case B (Floor Limitations Resulting)

| | Period Ending 12/31/X1 | | | Period Ending 12/31/X2 | | |
| | | LCM | | | LCM | |
	Cost	Without Limits	With Limits	Cost	Without Limits	With Limits
Sales............	$ 67	$ 67	$ 67	$ 65	$ 65	$ 65
Cost of Sales:						
Available.....	120	120	120			
Less: Ending Inventory....	60	57[1]	58[2]			
Cost of Goods Sold	60	63	62	60	57[3]	58[1]
Gross Margin.....	7	4	5	5	8	7
Selling Expenses.	3	3	3	3	3	3
Net Income (loss)	$ 4	$ 1	$ 2	$ 2	$ 5	$ 4

Notes: 1) See Note (1) in Case A above.
   2) Valued at floor, i.e., $65 - $3 = $62 ceiling
                $62 - $4 = $58 floor
          Since replacement cost ($57) is below floor, we are limited to the floor.
   3) See Note (3) in Case A above.