

TWO EXAMPLES OF NEW REPORTING UNDER SFAS 154

Example 1: Voluntary change in principle. One example of “retrospective application” for a voluntary change in principle would be a switch from FIFO to average cost in inventory reporting method. Under APB Opinion 20, this change was not considered to be retrospective. The “cumulative effect” on prior years’ income from the changes was reported in the current income statement. There were no changes to prior financial statements presented, except to report “pro forma income,” or what the income in those periods would have been had the new method been used in those periods.

Assume XYZ Company made this change in 2005, maintaining that average cost is the preferable inventory method. Net income under FIFO in 2003 was \$100,000, and in 2004 it was \$150,000. For the sake of simplicity, assume that XYZ began in 2003, and also assume no taxes. The corresponding income figures would have been \$85,000 and \$120,000, respectively, under average cost. XYZ is required to make the following journal entry in 2005:

Dr. Retained Earnings	\$45,000
Cr. Inventory	\$45,000

Under SFAS 154, XYZ is also required to provide a retrospective application of this change to its prior financial statements presented. Under the pre-SFAS 154 approach, the journal entry in 2005 would have been:

Dr. Cumulative Effect	\$45,000
Cr. Inventory	\$45,000

“Cumulative effect” is an income statement account. No retrospective application took place. Instead, the pro forma income reportable in 2003 and 2004 would have been \$85,000 and \$120,000, respectively, as though average cost had been applied in those years.

Example 2: Change in estimate. One example of a change in estimate effected by a change in principle is a change in depreciation method from straight-line to sum-of-the-years’-digits (SYD). Assume the firm in question considers SYD to be preferable. Under APB Opinion 20, this change was handled by reporting the cumulative effect on prior periods’ income in the current income statement along with the pro forma incomes for the prior periods presented. Under SFAS 154, this change is handled entirely prospectively. Accordingly, the new method (SYD) is applied to measuring current income as of the beginning of the current period.

In 2005, XYZ Company made this switch for a truck costing \$500,000 in 2003, having an expected life of five years at the time of purchase. Thus, accumulated depreciation through the end of 2004 was \$200,000, and the book value of the truck was \$300,000. The depreciation under SYD in 2005 is \$150,000 (i.e., $3/6 \times \$300,000$), to be reported in the income statement for this period. □