CHAPTER 6
INVENTORIES AND COST OF SALES

Chapter Outline

Notes

I. Inventory Basics

A. Determining Inventory Items
Includes all goods that a company owns and holds for sale.

1. Goods in transit—included if ownership has passed.
2. Goods on consignment—owned by consignor.
3. Goods damaged or obsolete—not included if they cannot be sold. If salable, included at a conservative estimate of their *net realizable value* (sales price minus cost of making the sale).

B. Determining Inventory Costs
Includes cost of expenditures necessary, directly or indirectly, in bringing an item to a salable condition and location.

1. Cost example: invoice price minus any discount, plus any incidental costs such as import duties, transportation-in, storage, insurance, etc.
2. *Matching principle* states that inventory costs should be recorded against revenue in the period when inventory is sold.
3. Exception: Under the *materiality principle* or the *cost-to-benefit constraint* (effort outweighs benefit), incidental costs of acquiring inventory maybe deemed immaterial and allocated to cost of goods sold in the period when they are incurred.

C. Internal Controls and Taking a Physical Count

1. The Inventory account under a perpetual system is updated for each purchase and sale.
2. Physical count is generally taken at the end of its fiscal year or when inventory amounts are low (at least once per year).
3. Physical inventory is used to adjust the Inventory account balance to the actual inventory on hand and thus account for theft, loss, damage, and errors.
4. Internal controls (such as pre-numbered inventory tickets, assigned primary and secondary counters, and manager confirmations) are applied when a physical count is taken.

II. Inventory Costing Under a Perpetual System—Accounting for inventory affects both the balance sheet and the income statement. There are 4 commonly used inventory costing methods. Each assumes a particular pattern of how cost flow through inventory. **Physical flow and cost flow need not be the same.**

A. Inventory Cost Flow Assumptions

Four methods of assigning costs to inventory and cost of goods sold are:

1. Specific identification—when each item in inventory can be identified with a specific purchase and invoice, we can use this method to assign actual cost of units sold to cost of goods sold and leave actual cost of units on hand in the inventory account.
2. First-in, first-out (FIFO)—when sales occur, the costs of the earliest units acquired are charged to cost of goods sold, leaving costs of most recent purchases in inventory.
3. Last-in, first-out (LIFO)—when sales occur, costs of the most recent purchases are charged to cost of goods sold, leaving costs of earliest purchases in inventory. (Note: LIFO comes closest to matching current costs against revenues.)
4. Weighted average (also called average cost)—requires we compute the weighted average cost per unit of inventory at the time of each sale (cost of goods available divided by units available). We charge this weighted average cost per unit times units sold to cost of goods sold.

   Note: Advanced computing technology has made perpetual inventory systems more affordable and more widely used.

B. Financial Statement Effects of Costing Methods

When purchase prices are different, the 4 costing methods nearly always assign different cost amounts. When costs *regularly rise*, note the following results:

1. FIFO assigns the lowest amount to cost of goods sold yielding the highest gross profit and the highest net income.
2. LIFO assigns the highest amount to cost of goods sold yielding the lowest gross profit and the lowest net income.
3. Weighted average method yields results between FIFO and LIFO.
4. Specific identification always yields results that depend on which units are sold.

Note: When costs *regularly decline* the reverse of above occurs for FIFO and LIFO.

All 4 methods are acceptable. Companies must disclose the method used in its financial statements or notes. Each method offers certain advantages:

1. FIFO assigns an amount to inventory on the balance sheet that approximates current replacement costs.
2. LIFO better matches current costs with revenues on the income statement.
3. Weighted average tends to smooth out erratic changes in costs.
4. Specific Identification exactly matches costs with revenues they generate.

C. Tax Effects of Costing Methods
Since inventory costs affect net income, they have potential tax effects. Companies can use different methods for financial reporting and tax reporting. *Exception*: When LIFO is used for tax purposes, IRS requires it be used for financial statements.

D. Consistency in Using Costing Methods

The *consistency principle* requires that a company use the same accounting methods period after period (for comparability) *unless* a change will improve financial reporting. *Full-disclosure principle* requires any change, its justification and effect of net income be reported.

III. Valuing Inventory at LCM and the Effects of Inventory Errors

A. Lower of Cost or Market (*LCM*)
Accounting principles require that inventory be reported on the balance sheet at market value when market is *lower* than cost.

1. *Market* in the term *LCM* is defined as replacement cost.
2. LCM is applied in *one* of three ways:
   a. to each individual item separately
   b. to major categories of products
   c. to the entire inventory.
3. When recorded cost is higher than replacement cost (market), inventory is adjusted downward and an increase to cost of goods sold is recorded.
4. LCM is often justified with reference to *conservatism principle***.**

4. Understated ending inventories result in understated assets and equity (on balance sheet), and an understated net income (on income statement) that period. Note: overstated ending inventories have the reverse effects.
5. Beginning inventory errors do not affect the balance sheet but do affect the current period's net income.