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Chapter 6 – Practice Problems

1. Why is the valuation of inventory of critical importance to managers and users of financial statements? Inventory is a significant current asset for a business, and as such, represents a large portion of the business' total assets.

   Inventory is a significant current asset and is a large portion of a business' total assets. An accurate representation of the business' inventory is crucial for anyone using a business' financial statements to ascertain the worth of a business. Managers must know the business' inventory to make better informed decisions about the business' future, and to recognize when the business is not doing very well. Moreover, investors and creditors look at inventory of a merchandising business to determine the business' worth and whether they should continue investing in the business.

2. Complete the following chart:

Inventory Valuation Method	**Method Description**	**Who would use this method?**	**Shortcomings**
FIFO	FIFO, first in – first out, is an inventory valuation method that assumes the earliest goods purchased are the first to be sold. This allows FIFO to reflect the physical flow of inventory. This assumption also means that COGS is comprised of the costs of the earliest goods purchased and that the ending inventory will most likely be recognized as the ending inventory.	During periods of inflation, FIFO reports a relatively lower COGS and a relatively higher ending inventory, resulting in a higher net income than what would be calculated using Average Cost of LIFO. During periods of deflation, the reverse is true: COGS is higher, ending inventory is lower, which makes the net income lower as well.	As FIFO understates COGS and overstates ending inventory during periods of inflation, it is also understating the COGP, which results in overstating the net income. The reverse applies during periods of deflation.
LIFO	LIFO, last in – first out assumes that the latest goods to be bought are the first to be sold and that the earliest goods purchased remain in the ending inventory. This causes the valuation method to rarely coincide with the actual flow of inventory. It also assumes that once a good is purchased, it is automatically assumed to be for sale, regardless of when it was bought.	During periods of deflation, investors, creditors, banks, and the government would want to use LIFO as it allows them to gain the most tax / interest from companies. Managers also would use this valuation method is they want the most accurate income statement.	LIFO can produce undesired net income effects and is not permitted for income tax purposes.
AC	Average Cost valuation treats all goods for sale as	Regardless of whether the current period is one of	

	identical. A weighted average is calculated to determine the unit cost, which is then used to determine a value for COGS and the ending inventory.	inflation or deflation, the average cost valuation method provides an accurate assessment of the business. This accuracy makes the average cost valuation method an ideal choice for all users of financial statements.	

3. Do the different methods of valuation produce the same results in a company's financial statements?

Inventory Valuation Method	**Result on a Company's F/S**
FIFO	During periods of inflation, FIFO reports the highest net income. During periods of deflation, FIFO reports the lowest net income. Moreover, FIFO produces the most accurate values on the balance sheet.
LIFO	During periods of inflation, LIFO reports the lowest net income. During periods of deflation, LIFO reports the highest net income.
AC	During periods of inflation, AC reports a net income between those produced by FIFO and LIFO.

4. How are the purchases of merchandise recorded under the different inventory valuation methods?

Inventory Valuation Method	**Result on a Company's F/S**
FIFO	Since FIFO recognizes the costs of the earliest goods purchased as COGS, the purchases at the beginning of the period are recorded as COGS and the purchases at the end of the period are recorded as ending inventory. This results in the most accurate value of purchases, as it most closely aligns with the flow of inventory.
LIFO	LIFO assumes that all goods purchased are to be for sale first, regardless of the date of purchase, which means that there is no division between beginning and ending inventories, resulting in an affected COGS.
AC	Average Cost falls in the middle between LIFO and FIFO for its effects on the purchases of merchandise.

5. How can purchase costs vary?

Just like how businesses adjust their costs to make money based on how well the country's economy is performing and how well the business is performing, wholesalers, who sell to retailers, are also businesses subject to these possibilities. Economic factors like whether it is currently a period of inflation or deflation affect the purchase costs. Moreover, as the demand and supply of products change, purchase costs can vary to follow supply and demand.

Dhrumil Patel

6. In Canada, we do not use one of the above-mentioned methods. Which one? Explain fully why not.

   We do not use the LIFO valuation method as it does not produce a very accurate valuation of the ending inventory, which appears on the balance sheet, causing undesired net income effects, making collecting the appropriate amount of tax difficult. Moreover, LIFO rarely corresponds to the true flow of inventory.

7. Explain the **Principle of Consistency** with regards to:

   i) Accounting Methods
   The same accounting methods must be used from period to period and changes in these accounting methods must be disclosed.

   ii) Inventory Valuation
   The consistency principle ensures that the business' chosen valuation method must remain consistent across periods. If the method were to change, it must be disclosed.

8. Once a company chooses a valuation method, does the Principle of Consistency allow the company to change the method? Explain.
   Since the consistency principle requires businesses to use the same valuation methods throughout periods for increased consistency, changing the method is highly discouraged. However, if the business must change the valuation method, the change must be fully disclosed.

9. Ammad Corporation sells cell phones at their location in downtown Toronto.

   a. They recently bought 100 blackberries @ $200 from RIM. Record the transaction.

DR Purchases	20,000
CR Bank	20,000

   b. There was a freight charge of $250 that Ammad Corporation must pay. Record the transaction.

DR Freight In	250
CR Bank	250

   c. After a few days, they found out that 3 cell phones were not functioning properly. So, they had to return them to RIM. Record the transaction.

DR Bank	600
CR Purchase Returns and Allowances	600

   d. The company bought another 100 blackberries @210 from RIM. The freight cost was $250. Record the 2 transactions.

DR Purchases	21,000
CR Bank	21,000

Dhrumil Patel

DR Freight In	250
CR Bank	250

e. By the end of the year, the company has sold 190 blackberries. Using FIFO, calculate the value of the inventory and COGS. Show all your calculations.

FIFO requires that the cost of earliest goods to be purchased be recognized as COGS and the cost of the latest goods to be purchased as the ending inventory. As such, the 100 blackberries bought at $200 each would be sold first. However, since 3 of the blackberries bought at $200 each were returned, only 97 of the original 100 can be sold, so 3 + 90 = 93 blackberries come from the ones bought at $210 each.

Ending Inventory = (97 + 100 – 93) * 210 = 1,470

COGS = Beginning Inventory + Cost of Goods Purchased – Ending Inventory + Freight In
COGS = 0 + 100 *200 + 100 * 210 – 3 * 200 – 10*210 – 1470 + 500
COGS = 97 * 200 + 90 * 210 – 1470 + 500
COGS = 39430