**Chapter 6 Homework**

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| --- | --- | --- | --- |
| K: / 4 | T: / 4 | A: / 4 | C: / 4 |

**To Be Handed In:**

**Questions: 1, 2, 3, 5, 11, 12, 14, 18**

1. The key to successful business operations is effective inventory management – Do you agree?

I agree that effective inventory management is crucial to maintaining and growing a merchandise business. An effective system for inventory management allows the business to keep track of goods sold and goods not sold. This is achieved through an efficient manner of dividing duties amongst employees, efficiently establishing the authenticity of each inventory item, having other employees ensure that the counts are accurate, documenting all inventory through tags, and having a designated supervisor ascertain that all inventory items are tagged appropriately. Determining the number of units of inventory takes the most time out of the three by far, as it requires a physical check and count. However, having an effective inventory management system means minimizing this time as much as possible. Moreover, a system for effective inventory management can increase the accuracy of financial statements like the value of the assets on the balance sheet, and the Cost of Goods Sold (COGS) on the income statement.

1. An item must possess 2 characteristics to be classified as inventory. What are they?

For an item to be classified as inventory, two characteristics must exist: the business must first own it, and the item must be valued using some specific valuation method. To determine if the business owns the item, 3 terms of sale must exist: FOB shipping – once the item is sold, the buyer owns it; FOB Destination – Buyer only has ownership of the products once they arrive, and ownership rests with the shipper until the product is sold, and not necessarily the business. The item must also be valued using some specific valuation method, which could be just-in-time, FIFO, average cost, or LIFO.

1. Tom Wetzel’s job taking physical inventory at Kikujiro’s Hardware Store.

Taking physical inventory is crucial to the inventory process and helps to present more accurate information on the business’ financial statements. This requires weighing, counting, or measuring in some other way each kind of inventory in the business. In a hardware store, this will most likely be counting the number of the types of tools and materials that the business currently owns.

1. What are the accounts that affect Purchases to yield the Cost of Goods Purchased? Are they added or deducted and what is their normal balance?

The cost of goods purchased is given by the formula Cost of Goods Purchased = Net Purchases + Freight In. Net Purchases is given by Purchases – Purchase returns and allowances. Purchase returns and allowances occur when the business returns inventory that was bought, and this account has a normal credit balance. Purchase returns and allowances are deducted from Purchases as Purchases represent the goods that the business was unable to sell. Returning goods would reduce the amount of goods that the business was unable to sell by reducing the total number of goods. Freight In represents any costs associated with transporting inventory and has a normal debit balance.

11. Name an advantage and a disadvantage of the specific identification method of inventory costing.

Inventory costing is a method that tracks the physical flow of goods by tagging each item with its specific unit cost. This method is frequently used when company sells few types of high-value items, like cars or land. This is very accurate for stating the inventory as it is throughout the period. However, this advantage has its drawbacks – this method is very time consuming, requiring every high-value item to be tagged.

12. Which assumed inventory cost flow method:

(a) usually parallels the actual physical flow of merchandise?

Just In Time valuation is a specific identification method tracks the actual physical flow of goods, by tagging each item of inventory with a specific unit cost. This is typically used when the business sells a few types of high-value cost items.

(b) assumes that the first units purchased are the first to be sold?

First in, First out valuation assumes that the first units purchased are the first to be sold and often reflects the actual flow of inventory. The cost of the earliest goods are the first to be recognized as a part of COGS, specifically as beginning inventory, and the costs of the most recent goods purchased are recognized as the ending inventory.

(c) assumes that the goods available for sale are identical?

Average Cost valuation assumes that the goods available for sale are identical, and so cost the same. A weighted average of all purchase costs is calculated to determine the average cost for each unit. This average cost is then applied to the units sold and units on hand to determine the COGS.

14. “The selection of an inventory cost flow method is a decision made by the accountants.” Do you agree? Once a method has been selected, what accounting requirement applies?

The inventory cost flow methods are specific identification, FIFO, average cost, and LIFO. The choice between the cost flow methods is actually made by managers, who choose a specific based on market forces. During periods of inflation, FIFO reports the highest net income, LIFO reports the lowest net income, and AC reports a net income between those two values. Depending on what would be best to show during inflation, the managers can choose one of the valuation methods that favours the business, like FIFO. However, the consistency principle states that the business must continue to use the chosen valuation method, which could be problematic if the country begins to enter a period of deflation, in which LIFO and FIFO’s benefits are reversed.

18. Maureen & Nathan Company’s balance sheet shows Inventories $162,800. What additional disclosures should be made?

To truly understand the value given by “Inventories”, a few more details must be made clear: Beginning Inventory, Ending Inventory, and Purchases. Beginning inventory is the inventory that has carried over from the previous period. Purchases contain the inventory purchases of a business. It’s used to calculate the amount of inventory available for sale. Finally, ending inventory is the amount of inventory available at the end of the period. Disclosing all three of these details will place “Inventories” into context, and enable the business to calculate its COGS, for example.

**Additional Questions:**

1. Explain the concept of Gross Profit. What is the formula? Why is it necessary?

Gross profit is the profit that the business is making after deducting COGS from Revenue. It’s found on the income statement and is given by Gross Profit = Revenue – COGS. Gross profit is necessary to determine the company’s efficiency at using its labour and supplies in producing goods and services.

1. Explain the full disclosure principle. What aspects of inventory must be disclosed in the financial statements and where?

The full disclosure principle states that a business must report all necessary information about their financial statements to people asking for it who have the expertise to understand and interpret the financial information. For the income statement, the beginning inventory and ending inventory must be stated, while only the ending inventory must be stated for the balance sheet.

**Exercise: E6-3**

|  |  |
| --- | --- |
| Merchandise Inventory | 17200 |
| Freight In | 4000 |
| Freight Out | 1000 |
| Purchases | 142400 |
| Purchase returns and allowances | 2000 |
| Ending Merchandise Inventory | 26000 |
| Cost of Goods Sold | 133,600 |

**Problems: P6-2A (part a only – ONLY journalize the transactions)**

For problem 6-2A, when journalizing the transactions, use current GAAP first and then do the question again with proposed GAAP.

P6-2

Current GAAP

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
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|  |  |  |  |  |
| # | **A/C #** | **Accounts** | **$ Amount** | |
|  |  |  | **DR** | **CR** |
| 5 | 5001 | 5001 (Purchases) | 1600 |  |
|  | 2200 | 2200 (Accounts Payable) |  | 1600 |
|  |  |  |  |  |
| 7 | 5509 | 5509 (Delivery, freight, and express expense) | 80 |  |
|  | 1000 | 1000 (Bank) |  | 80 |
|  |  |  |  |  |
| 9 | 2200 | 2200 (Accounts Payable) | 100 |  |
|  | 5003 | 5003 (Purchase Returns and allowances) |  | 100 |
|  |  |  |  |  |
| 10 | 1020 | 1020 (Accounts Receivable) | 900 |  |
|  | 4000 | 4000 (Revenue) |  | 900 |
|  |  |  |  |  |
| 12 | 5001 | 5001 (Purchases) | 660 |  |
|  | 2200 | 2200 (Accounts Payable) |  | 660 |
|  |  |  |  |  |
| 14 | 2200 | 2200 (Accounts Payable) | 1500 |  |
|  | 1000 | 1000 (Bank) |  | 1500 |
|  |  |  |  |  |
| 17 | 2200 | 2200 (Accounts Payable) | 60 |  |
|  | 5003 | 5003 (Purchase Returns and allowances) |  | 60 |
|  |  |  |  |  |
| 20 | 1020 | 1020 (Accounts Receivable) | 700 |  |
|  | 4000 | 4000 (Revenue) |  | 700 |
|  |  |  |  |  |
| 21 | 2200 | 2200 (Accounts Payable) | 600 |  |
|  | 1000 | 1000 (Bank) |  | 600 |
|  |  |  |  |  |
| 27 | 4101 | 4101 (Sales returns and allowances) | 30 |  |
|  | 1020 | 1020 (Accounts Receivable) |  | 30 |
|  |  |  |  |  |
| 30 | 1000 | 1000 (Bank) | 600 |  |
|  | 4000 | 4000 (Revenue) |  | 600 |
|  |  |  |  |  |
|  | 1000 | 1000 (Bank) | 1100 |  |
|  | 1020 | 1020 (Accounts Receivable) |  | 1100 |

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| **Kane's Pro Shop** | | |
| **BALANCE SHEET** | | |
| **AS AT April 30, 2003** | | |
|  |  |  |
|  |  | **2003** |
|  |  | **$** |
| **ASSETS** |  |  |
| Current |  |  |
|  | Cash | 2,020 |
|  | Accounts receivable | 470 |
|  |  | 2,490 |
|  |  |  |
| Long-term |  |  |
|  |  |  |
|  |  | $ 2,490 |
|  |  |  |
| **LIABILITIES** |  |  |
| Current |  |  |
|  |  |  |
| Long-term |  |  |
|  |  |  |
| **OWNER'S EQUITY** |  |  |
|  | Owner's capital | 6,000 |
|  | Net loss | (3,510) |
|  |  | 2,490 |
|  |  |  |
|  |  | $ 2,490 |

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| **Kane's Pro Shop** | | | |
| **INCOME STATEMENT** | | | |
| **FOR THE YEAR ENDING April 30, 2003** | | | |
|  |  |  |  |
|  |  |  | **2003** |
|  |  |  | **$** |
| Revenue |  |  |  |
|  | Revenue |  | 2,200 |
|  | Sales returns and allowances |  | (30) |
|  |  |  | $ 2,170 |
|  |  |  |  |
| Cost of goods sold |  |  |  |
|  | Inventory - opening |  | 3,500 |
|  | Purchases |  | 2,260 |
|  | Purchase returns and allowances |  | (160) |
| Cost of goods sold |  |  | 5,600 |
|  |  |  |  |
| Gross profit |  |  | (3,430) |
|  |  |  |  |
| Operating expenses |  |  |  |
|  | Office expenses |  | 80 |
|  |  |  | 80 |
|  |  |  |  |
| Income before income taxes |  |  | (3,510) |
|  |  |  |  |
|  |  |  |  |
| Net loss for the year |  |  | $ (3,510) |

Proposed:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
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|  |  |  |  |  |
| # | **A/C #** | **Accounts** | **$ Amount** | |
|  |  |  | **DR** | **CR** |
| 5 | 5001 | 5001 (Purchases) | 1440 |  |
|  | 1056 | 1056 (Prepaid - others) | 160 |  |
|  | 2200 | 2200 (Accounts Payable) |  | 1600 |
|  |  |  |  |  |
| 7 | 5509 | 5509 (Delivery, freight, and express expense) | 80 |  |
|  | 1000 | 1000 (Bank) |  | 80 |
|  |  |  |  |  |
| 10 | 1020 | 1020 (Accounts Receivable) | 900 |  |
|  | 2100 | 2100 (Unearned Revenue) |  | 90 |
|  | 4000 | 4000 (Revenue) |  | 810 |
|  |  |  |  |  |
| 12 | 5001 | 5001 (Purchases) | 594 |  |
|  | 1056 | 1056 (Prepaid - others) | 66 |  |
|  | 2200 | 2200 (Accounts Payable) |  | 660 |
|  |  |  |  |  |
| 14 | 2200 | 2200 (Accounts Payable) | 660 |  |
|  | 1000 | 1000 (Bank) |  | 660 |
|  |  |  |  |  |
| 20 | 1020 | 1020 (Accounts Receivable) | 700 |  |
|  | 2100 | 2100 (Unearned Revenue) |  | 70 |
|  | 4000 | 4000 (Revenue) |  | 630 |
|  |  |  |  |  |
| 21 | 2200 | 2200 (Accounts Payable) | 660 |  |
|  | 1000 | 1000 (Bank) |  | 660 |
|  |  |  |  |  |
| 30 | 1000 | 1000 (Bank) | 600 |  |
|  | 2100 | 2100 (Unearned Revenue) |  | 60 |
|  | 4000 | 4000 (Revenue) |  | 540 |
|  |  |  |  |  |
|  | 1000 | 1000 (Bank) | 1100 |  |
|  | 1020 | 1020 (Accounts Receivable) |  | 1100 |
|  |  |  |  |  |
|  | 1000 | 1000 (Bank) | 100 |  |
|  | 5001 | 5001 (Purchases) | 60 |  |
|  | 1056 | 1056 (Prepaid - others) |  | 160 |
|  |  |  |  |  |
|  | 1000 | 1000 (Bank) | 60 |  |
|  | 5001 | 5001 (Purchases) | 6 |  |
|  | 1056 | 1056 (Prepaid - others) |  | 66 |
|  |  |  |  |  |
|  | 2100 | 2100 (Unearned Revenue) | 220 |  |
|  | 1020 | 1020 (Accounts Receivable) |  | 30 |
|  | 4000 | 4000 (Revenue) |  | 190 |

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| **Kane's Pro Shop** | | |
| **BALANCE SHEET** | | |
| **AS AT April 30, 2003** | | |
|  |  |  |
|  |  | **2003** |
|  |  | **$** |
| **ASSETS** |  |  |
| Current |  |  |
|  | Cash | 2,960 |
|  | Accounts receivable | 470 |
|  |  | 3,430 |
|  |  |  |
| Long-term |  |  |
|  |  |  |
|  |  | $ 3,430 |
|  |  |  |
| **LIABILITIES** |  |  |
| Current |  |  |
|  | Accounts payable | 940 |
|  |  | 940 |
|  |  |  |
| Long-term |  |  |
|  |  | 940 |
|  |  |  |
| **OWNER'S EQUITY** |  |  |
|  | Owner's capital | 6,000 |
|  | Net loss | (3,510) |
|  |  | 2,490 |
|  |  |  |
|  |  | $ 3,430 |

|  |  |  |  |
| --- | --- | --- | --- |
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|  |  |  |  |
| **Kane's Pro Shop** | | | |
| **INCOME STATEMENT** | | | |
| **FOR THE YEAR ENDING April 30, 2003** | | | |
|  |  |  |  |
|  |  |  | **2003** |
|  |  |  | **$** |
| Revenue |  |  |  |
|  | Revenue |  | 2,170 |
|  |  |  | $ 2,170 |
|  |  |  |  |
| Cost of goods sold |  |  |  |
|  | Inventory - opening |  | 3,500 |
|  | Purchases |  | 2,100 |
| Cost of goods sold |  |  | 5,600 |
|  |  |  |  |
| Gross profit |  |  | (3,430) |
|  |  |  |  |
| Operating expenses |  |  |  |
|  | Office expenses |  | 80 |
|  |  |  | 80 |
|  |  |  |  |
| Income before income taxes |  |  | (3,510) |
|  |  |  |  |
|  |  |  |  |
| Net loss for the year |  |  | $ (3,510) |

**Note: use templates where required.**