CH 5 — Inventory and Cost of Goods

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I. Financial Statements for Merchandising Companies

Key differences from service companies

- **Balance Sheet:** Merchandising companies report **Inventory** as a **Current Asset** (a "somewhat liquid" asset).
- **Income Statement:** Includes **Sales Revenue**, **Cost of Goods Sold (COGS)**, and **Gross Profit** (Gross Margin).
  - $\text{Gross Profit} = \text{Sales Revenue} - \text{Cost of Goods Sold}$
  - **COGS** is classified as an **expense**.

Merchandise inventory fundamentals

- **Inventory:** Cost of inventory still on hand; **Asset** on the Balance Sheet.
- **Cost of Goods Sold (COGS):** Cost of inventory that has been sold; **Expense** on the Income Statement.

Determining inventory cost

$$\text{Inventory Cost} = \text{Basic Purchase Price} + \text{Freight-in, insurance in transit, and ready-to-sell costs} - \text{Returns, allowances, and discounts}$$

Goods in transit (shipping terms) — determines who owns inventory while shipped.

II. Perpetual Inventory System (LO 1)

Characteristics

- Used for all types of goods.
- Keeps a **running total** of goods bought, sold, and on hand.
- Often uses bar codes to record sales and update inventory automatically.

Recording inventory transactions

Calculations

- $\text{Net Purchases} = \text{Purchase Price} + \text{Freight-in} - \text{Purchase Returns} - \text{Purchase Allowances} - \text{Purchase Discounts}$
- $\text{Net Sales} = \text{Sales Revenue} - \text{Sales Returns and Allowances} - \text{Sales Discounts}$

Sales adjustments (returns and discounts)

1. **Sales Returns & Allowances:** If returns are expected, record:
   - **Accrued liability: Sales Refund Payable** for sales price of expected returns.
   - **Asset adjustment: Estimated Inventory Returns** to adjust inventory and COGS for expected returns.
   - **Example (both price & cost effects):**
     - Price side: Debit **Cash/A/R**; Credit **Sales Revenue** & **Sales Refund Payable**.
     - Cost side: Debit **COGS** & **Inventory Returns Estimated**; Credit **Inventory**.
2. **Sales Discounts:** e.g., **2/10, n/30** → 2% discount if paid within 10 days; otherwise net in 30 days.
   - If buyer takes the discount, **Sales Discounts** is **debited**.

III. Inventory Costing Methods (LO 2)

Purpose: Determine **COGS** (income statement) and **Ending Inventory** (balance sheet).

1. **Specific Identification:** Unique items (e.g., automobiles, antiques). Each unit at its specific cost.
2. **FIFO (First-in, First-out):**
   - Assumes **oldest** items are sold first.
   - Ending inventory is the **most recent** costs.
3. **Weighted-Average Cost:** Uses average cost of all units available during the period for sales and ending inventory.

Impact when inventory costs are increasing