ACCOUNTING FOR INVENTORIES

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Inventory consists of all goods held for resale during the regular course of business. A merchandising company may value inventory periodically (annual, semi-annual, etc.) or perpetually (as sold). Because inventories represent such a large cost, careful application of the matching principle (expenses are matched with the sales they generate) is of primary importance.

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I. ALTERNATIVE VALUATION METHODS

Below are the periodic inventory methods available to Darin's Music Emporium and a comparison of methods. The Weighted Average Method was eventually chosen to value the 3,000 units of ending inventory because, as explained below, it tended to reasonably represent cost of goods sold and the value of ending inventory.

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BASIC DATA

Jan. 1	Beginning Inventory	2,000 units @ \$5.20	\$10,400
April 15	Purchase	3,000 units @ \$5.60	16,800
Aug. 20	Purchase	4,000 units @ \$6.00	24,000
Dec. 2	Purchase	1,000 units @ \$6.30	6,300
		10,000 units	\$57,500

SPECIFIC IDENTIFICATION METHOD (SI)

1,000	units from Beginning Inventory	1,000 @ \$5.20 = \$5,200
500	units from April 15 Purchase	500 @ \$5.60 = 2,800
1,000	units from Aug. 20 Purchase	1,000 @ \$6.00 = 6,000
500	units from Dec. 2 Purchase	500 @ \$6.30 = 3,150
3,000		\$17,150

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FIRST-IN, FIRST-OUT METHOD (FIFO)

1,000 units @ \$6.30 =	\$ 6,300
2,000 units @ \$6.00 =	12,000
3,000 units	\$18,300

LAST-IN, FIRST-OUT METHOD (LIFO)

2,000 units @ \$5.20 =	\$10,400
1,000 units @ \$5.60 =	5,600
3,000 units	\$16,000

Note: With First-In, First-Out, earlier purchases are charged to Cost of Goods Sold and inventory is valued at the cost of later purchases. LIFO is the opposite of FIFO. The use of either method does not require the distribution of inventory in any particular order.

WEIGHTED AVERAGE METHOD (WA)

$$\text{Average Price} = \frac{\text{Total Cost}}{\text{Total Units}} = \frac{\$57{,}500}{10{,}000 \text{ units}} = \$5.75/\text{unit}$$

$$\begin{aligned}\text{Inventory Value} &= (\text{Average Price})(\text{Ending Units}) \\ &= (\$5.75/\text{unit})(3{,}000 \text{ units}) \\ &= \$17{,}250\end{aligned}$$

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COMPARING METHODS

	SI	FIFO	LIFO	WA
Sales	\$100,000	\$100,000	\$100,000	\$100,000
Cost of Goods Sold:				
Beginning Inventory	10,400	10,400	10,400	10,400
Purchases	47,100	47,100	47,100	47,100
Cost of Goods Available	\$57,500	\$57,500	\$57,500	\$57,500
Less Ending Inventory	17,150	18,300	16,000	17,250
Cost of Goods Sold	\$40,350	\$39,200	\$41,500	\$40,250
Gross Profit on Sales	\$59,650	\$60,800	\$58,500	\$59,750

Cost of Goods Available is distributed to either ending inventory or cost of goods sold. During rising prices, LIFO assigns high priced later purchases to cost of goods sold lowering profits and taxes. Earlier low priced purchases are assigned to inventory which is thus understated. The vice versa is true for FIFO.

Frequent changes from one method to another are not allowed because of the consistency principle. When changes do occur, the full disclosure principle requires that the effect on income be disclosed in notes attached to statements.

Note: We are going to leave Darin's Music Emporium for the rest of this Learning Unit. His adventure will return next unit.

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