QuickNotes

Topic 4

Inventory

QuickNotes

Session Objectives

- Understand the need for adjustment for inventory in preparing financial statements
- Describe how opening and closing inventory appears in the profit and loss accounts
- Prepare inventory account with including opening and closing Inventory
- Explain IAS 2 requirement regarding valuation of closing Inventory

QuickNotes

Session Objectives

- Define cost and net realisable value of closing inventory
- Discuss inventory valuation methods
- Explain the IASB requirements for inventories
- Explain the use of continuous and period-end inventory records

QuickNotes

Inventory Adjustments

Opening Inventory

Added to

Cost of Sales

Deducted from

Closing Inventory

Inventory Valuation and Income Measurement

£ Value Assigned to Inventory on Balance Sheet

When Sold =

£ Value Expensed on Income Statement as Cost of Goods Sold

Cost of Goods Sold

Cost of Goods Sold
= Opening inventory + Purchases or production costs – closing inventory value

Calculating Cost of Goods Sold

- **Internal calculation**

	Opening inventory	£ 30,000
+	Purchases	100,000
=	Cost of goods available for sale	130,000
-	**Closing inventory**	**40,000**
=	**Cost of goods sold**	**£ 90,000**

Calculating Cost of Goods Sold

- Internal calculation

Opening inventory
\+ Purchases
= Cost of goods available for sale
\- Closing inventory
= Cost of goods sold

- As presented on Profit & Loss Account

Sales	**£200,000**
Cost of goods sold	**90,000**
Gross margin	**110,000**
:	
:	
Net income	**£ 30,000**

Carriage

- Carriage inwards is the cost paid by purchaser of having goods transported to his business
  - It is added to cost of purchases
- Carriage outwards is the cost to the seller paid by the seller of having goods transported to the customer
  - It is a selling and distribution expense

Accounting for Inventories

Purchases
DEBIT Purchases
CREDIT Cash or payables
(This does not touch inventory account at all)

Transfer of purchases to Income Statement
DEBIT Income Statement
CREDIT Purchases

Balance in inventory account is still opening inventory balance. Also transferred to Income Statement
DEBIT Income Statement
CREDIT Inventory

Closing inventory transferred to Income Statement
DEBIT Inventory
CREDIT Income Statement

Summary of Treatment

- Sales and Purchases → Profit & Loss Account
- Opening Inventory → Profit & Loss Account
- Closing Inventory → Inventory Account
  - Profit & Loss Account
  - → Balance Sheet *(Under Current Assets)*
- NOTE: Closing Inventory becomes the opening Inventory for the next period

Entry for Inventory Drawings

DEBIT Drawings (Cost of inventory taken)
CREDIT Cost of Sales (Cost of inventory taken)

QuickNotes

What is Included Under Inventory

- Goods purchased for resale
- Consumable stores
- Raw materials and components
- Partly finished goods
- Finished goods

QuickNotes

Value of Inventory

- Included in balance sheet at lower of:
  - Cost
    - Cost = Purchase price material + import duties + cost of conversion
  - Net Realisable Value
    - Expected selling price less future costs

QuickNotes

Inventory: Important Concepts

- Prudence:
  - Anticipated revenues and profits have no place in a profit and loss account until they are realised with reasonable certainty.
  - Provision should be made for all known expenses and losses
  - Requires that Inventory be carried forward at a realistic value or a value at which they can be realised.

QuickNotes

Inventory: Important Concepts

- Matching:
  - Recording the revenues earned during a period using the revenue realization principle and matching (offsetting) the revenues with the expenses incurred in generating this revenue.
  - Justifies carrying forward of purchases not sold by the end of accounting period.

Methods of Calculating Cost of Inventory

- Unit cost or actual cost of purchasing
- First –in- First-out or FIFO
- Average Cost or AVCO

IAS 2 does not allow LIFO

Key Points in IAS 2

- Inventory is measured at lower of cost or net realisable value
- Cost includes cost incurred in normal course of business in bringing the product to the present location and condition
- Inventory can include raw material, WIP, finished goods etc
- FIFO and AVCO are allowed while LIFO is not allowed for valuing Inventory

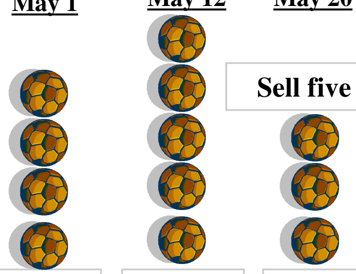
Unit Cost

- Actual cost of purchasing identifiable units of Inventory
- Used in the case of high value items that can be individually distinguished
- Examples: Art dealers and Jewellers

Illustration

May 1 **May 12** **May 20**

Sell five balls on May 31



Cost = £10.00 ea.	Cost = £10.20 ea.	Cost = £10.50 ea.

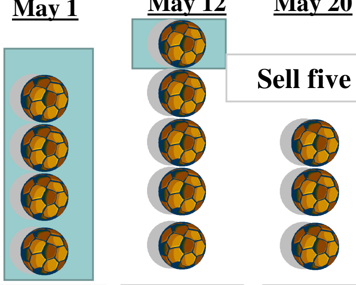
FIFO METHOD

FIFO

- A method of inventory control where the cost of goods sold is based on the price of the product first placed in store. It is assumed that the product first placed in store is used before more recently produced or acquired goods or materials.
- The assumption is made for costing purpose

Illustration: FIFO

May 1 | May 12 | May 20



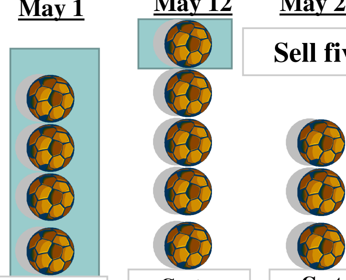
Sell five balls on May 31

Cost = £10.00 ea. | Cost = £10.20 ea. | Cost = £10.50 ea.

First balls purchased are assumed first sold

Illustration: FIFO

May 1 | May 12 | May 20



Sell five balls on May 31

Cost = £10.00 ea. | Cost = £10.20 ea. | Cost = £10.50 ea.

Cost of Goods Sold

£10.00
10.00
10.00
10.00
10.20
£50.20

PERIODIC SIMPLE AVERAGE METHOD

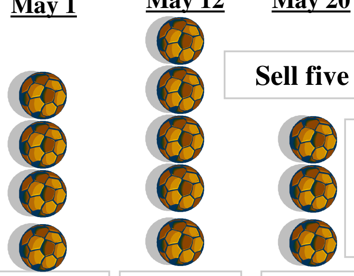
Illustration: Simple Average

May 1	May 12	May 20
Cost = £10.00 ea.	Cost = £10.20 ea.	Cost = £10.50 ea.

Sell five balls on May 31

Assigns same unit cost to all units of inventory available for sale during a period

Illustration: Simple Average

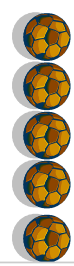


May 1	May 12	May 20
Cost = £10.00 ea.	Cost = £10.20 ea.	Cost = £10.50 ea.

Sell five balls on May 31

Average Cost = £10.23/ball
[£10) + £10.20) + £10.50)] /3

Illustration: Simple Average



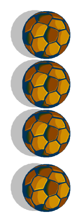
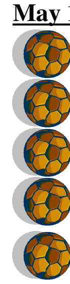
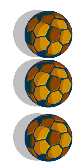
Cost of Goods Sold
5 cameras @ £10.23 (rounded) = £51.15

Average Cost = £10.23/camera

WEIGHTED AVERAGE METHOD

Illustration: Weighted Average

May 1 | May 12 | May 20

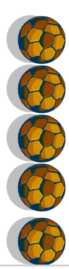




Sell five balls on May 31

Weighted Average Cost = £10.21/ball [(4 @ £10) + (5 @ £10.20) + (3 @ £10.50)] /12

Cost = £10.00 ea. | Cost = £10.20 ea. | Cost = £10.50 ea.

Illustration: Weighted Average



Cost of <u>Goods Sold</u> 5 balls @ £10.21 (rounded) = £51.05

Weighted Average Cost = £10.21/ball

Profit and Loss Effects

- In periods of increasing prices
  - FIFO reports the highest net income
  - average cost falls in the middle.
- In periods of decreasing prices
  - FIFO will report the lowest net income
  - average cost in the middle.

QuickNotes

Impact of Valuation Methods on Financial Statements

- If inventory is overvalued
  - Assets are overstated in the Balance Sheet
  - Profit is overstated in the Income Statement
- If inventory is undervalued
  - Assets are understated in the Balance Sheet
  - Profit is understated in the Income Statement

QuickNotes

IAS 2 Inventory and Long Term Contracts

- Inventory is measured at lower of cost or net realisable value
- Cost includes cost of purchases, cost of conversion and other costs incurred in bringing the product to the present location and condition
- Cost excluded are selling cost, storage cost, abnormal waste and administrative overheads
- FIFO and AVCO are allowed while LIFO is not allowed for valuing inventory
- Disclosure must be made about the accounting policy for inventory

QuickNotes

Methods of Inventory Taking

- Continuous inventory taking
- Period-end inventory records

QuickNotes

Continuous Inventory Taking: Merits

- There is better information for inventory control
- Excessive build-up of certain lines of inventory and having insufficient Inventory of other lines are avoided
- Less work is needed to calculate inventory at the end of accounting period

Period-end Inventory Taking: Merits

- Cheaper option
- Is inevitable to a certain extent even when there is continuous inventory taking