Name: \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Chapter 6 Notes**

**Inventory Planning and Valuation**

**6.1: The Nature of Merchandise Inventory**

**Flow of Inventory Costs**

The cost of the merchandise available for sale consists of:

1. The cost of the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ merchandise inventory.
2. The cost of the \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ added to the inventory during the fiscal period.

At the end of each fiscal period, the cost of merchandise available for sale is divided into:

1. *The cost of the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ merchandise inventory*. This represents a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ asset that will be charged as costs in \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ fiscal periods.
2. *The cost of the merchandise \_\_\_\_\_\_\_\_\_\_\_\_\_ during the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ fiscal period*. This cost materially affects the amount of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ reported for the fiscal period.

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Merchandise Inventory

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Merchandise Inventory

Cost of Merchandise \_\_\_\_\_\_\_\_\_\_\_\_\_

Cost of Merchandise Available for \_\_\_\_\_\_\_\_\_

Net  
\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Effects of Errors in Costing an Inventory**

* An accurate merchandise \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ must be determined to adequately report the financial \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ of a merchandising business.
* The effects of an understated or overstated ending inventory is described on the chart on page 171 of your textbook.

**Costing and Counting the Inventory**

* **\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_** - items in the merchandise inventory of a merchandising business, includes:

1. price paid to \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ for the merchandise (less discounts, returns, and allowances)
2. cost involved in \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ the goods to the place of business and ready for sale (transportation, shipping, etc.)

* *Two Methods for Determining Number of Goods in Inventory*

1. Taking a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ count of the individual items in inventory.
2. Keeping a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ record for each merchandise item showing the number \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and the number \_\_\_\_\_\_\_\_\_\_\_\_\_\_.

* **Goods in Transit**
  + For goods in transit at the time of a physical count of inventory, the business must determine who holds the \_\_\_\_\_\_\_\_\_\_\_\_ to the goods.
  + When in transit and the title passes from the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ to the \_\_\_\_\_\_\_\_\_\_\_\_\_, the goods become part of the buyer’s \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ regardless of where they are physically located.
    - **FOB Shipping Point** = F\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ O\_\_\_\_\_ B\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ shipping point. This means that the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ pays the transportation charges and the title to the goods passes to the buyer as soon as the vendor \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ the goods to a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ business. The goods in transit, but not yet \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ by the buyer are part of the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inventory.
    - **FOB Destination** = Free on Board destination. This means the \_\_\_\_\_\_\_\_\_\_\_\_\_ pays the transportation charges and the title to the goods passes to the buyer when the buyer \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ the goods. The goods in transit, but not yet \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ by the buyer are part of the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inventory.
* **Goods on Consignment**
  + **Consignment** -
  + **Consignee** -
  + **Consignor** -
  + The consignee agrees to \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, and attempt to \_\_\_\_\_\_\_\_\_\_\_ the consigned goods. If the goods are sold, the consignee deducts a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ from the sale amount. The title to the goods does not pass to the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. The goods on consignment are part of the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inventory.

**Stock Record for a Perpetual Inventory System**

* **Perpetual Inventory** -   
  + This provides \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ records about the quantity of merchandise on \_\_\_\_\_\_\_\_\_\_\_\_\_\_.
  + **Stock Record** -
  + **Stock Ledger** -
  + **Purchase Order** -
  + During the year, sales are recorded on the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ when the sale is made. Purchases are record on the stock record when goods are \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

**Inventory Record Used for the Periodic Inventory**

* **Periodic Inventory** -   
  + Counting, weighing, or measuring merchandise on hand for a periodic inventory is commonly referred to as “\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_”. For businesses with a large \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ of merchandise on hand, this is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. Therefore, businesses usually only take a periodic inventory once each \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.
  + When only a periodic inventory is used, the \_\_\_\_\_\_\_\_\_\_\_ quantity of a merchandise item can be \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. Therefore some businesses use a perpetual inventory and then complete a periodic inventory once each year to check the accuracy of the perpetual inventory.
  + **Inventory Record** -

**Practice Problem**

*A stock record form and an inventory record form for Tower Television are provided below.*

1. Fill in the top portion of the stock record form with the following information: Description, 19” color television set; Stock No., K087; Reorder, 80; Minimum, 20; and Location, Bin 12.
2. Record the following information.

**Purchase Sales**

**Date Invoice No. Invoice No. Quantity Balance**

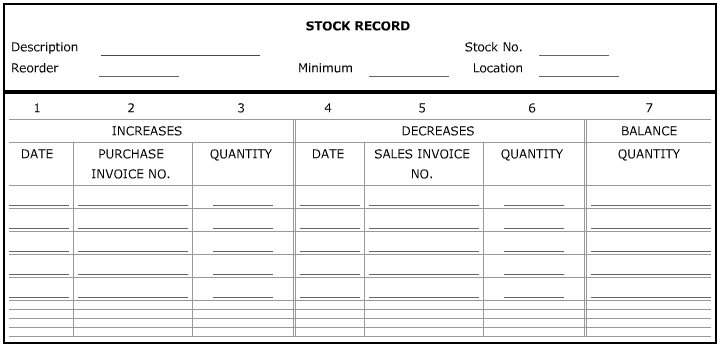
Sept. 1 62

Sept. 12 475 40

Sept. 16 508 8

Sept. 17 183 80

Sept. 20 653 15



**6.2: Inventory Costing**

**First-In, First-Out Inventory Costing Method**

* **First-In, First-Out Inventory Costing Method** (aka FIFO) -   
  + Assumes that the merchandise purchased \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ (first in) is the merchandise sold \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ (first out). Thus, FIFO uses the most \_\_\_\_\_\_\_\_\_\_\_\_ purchase prices to determine the cost of merchandise inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

**Last-In, First-Out Inventory Costing Method**

* **Last-In, First-Out Inventory Costing Method** (aka LIFO) -   
  + Assumes that the merchandise purchased \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ (last in) is the merchandise sold \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ (first out). Thus, FIFO uses the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ purchase prices to determine the cost of merchandise inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.

**Weighted-Average Inventory Costing Method**

* **Weighted-Average Inventory Costing Method** -   
  + Assumes that the cost is an \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ of the price paid for similar items purchased during the fiscal period. The total cost is divided by the total units \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ to calculate the weighted-average cost per \_\_\_\_\_\_\_\_\_\_\_\_.

**Costing Inventory During Periods of Increasing Prices**

* The cost of ending inventory affects the cost of merchandise \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ amount on the income statement. Therefore, if prices are rising, the three methods of costing inventory have different results on the reported net income:

**If prices are rising: FIFO LIFO Weighted-Average**

Ending inventory valuation Highest \_\_\_\_\_\_\_\_\_\_\_\_ Always falls

Cost of merchandise sold Lowest \_\_\_\_\_\_\_\_\_\_\_\_ between

Reported net income Highest \_\_\_\_\_\_\_\_\_\_\_\_ FIFO and LIFO

**Costing Inventory During Periods of Decreasing Prices**

* In a period of decreasing prices, the three methods of costing inventory have the following effects on the report net income:

**If prices are decreasing: FIFO LIFO Weighted-Average**

Ending inventory valuation Lowest \_\_\_\_\_\_\_\_\_\_\_\_ Always falls

Cost of merchandise sold Highest \_\_\_\_\_\_\_\_\_\_\_\_ between

Reported net income Lowest \_\_\_\_\_\_\_\_\_\_\_\_ FIFO and LIFO

**Results of the Three Inventory Costing Methods Compared**

* The weighted-average method usually results in a total cost \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ the FIFO and LIFO total costs. This results in more \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ reporting of merchandise inventory costs.
* Each business selects the method of costing merchandise inventory that bits fits its \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. A business selects \_\_\_\_\_\_\_\_\_\_ method and uses it for a number of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ so that information on a series of \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ statements can be compared easily.

**Lower of Cost or Market Inventory Costing Method**

* **Lower of Cost or Market Inventory Costing Method** -   
  + *Market* refers to the .
  + When the merchandise is purchased, the \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ is used to record inventory costs. If the unit price is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ than the market price at the end of a fiscal period, the inventory cost is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ to the current market price. However, if the unit price is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ than the market price, the inventory cost is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ at the unit price.
  + Two amounts are needed to apply the lower of cost or market method:

1. The cost of inventory using the \_\_\_\_\_\_\_\_\_\_, \_\_\_\_\_\_\_\_\_\_\_, or \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ method.
2. The current \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ price of the inventory.
   * These two amounts are then \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and the lower of the two is used to cost the inventory.

**Practice Problem**

*Forms for calculating inventory costs for Cassie’s Kitchen are provided below.*

1. Cassie’s Kitchen had the following beginning inventory and purchases for a salad maker, stock number T1150. At the end of the year, 140 units remained in ending inventory. Determine the cost of the ending inventory using the FIFO, LIFO, and weighted-average inventory costing methods.

**Units Unit Price**

January, Beginning Inventory 120 $20.00

July, Purchase 100 $22.00

October, Purchase 100 $27.60

**FIFO:**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ units from October purchase @ \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ units from July purchase @ \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Cost of ending inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**LIFO:**

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ units from January purchase @ \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\_\_\_\_\_\_\_\_\_\_\_\_\_\_ units from July purchase @ \_\_\_\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Cost of ending inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Weighted-Average:**

Total units available for sale \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Cost of units available for sale \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

Average cost \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

\_\_\_\_\_\_\_\_\_ units @ \_\_\_\_\_\_\_\_ average cost \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**6.3: Estimating the Inventory**

**Gross Profit Method of Estimating Inventory**

* A business that keeps periodic inventory records and prepares monthly interim financial statements needs a \_\_\_\_\_\_\_\_\_\_ to use for monthly \_\_\_\_\_\_\_\_\_\_\_\_\_\_ merchandise inventory. Taking a monthly periodic inventory is usually too \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, so monthly ending inventories may be \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.
* **Gross Profit Method of Estimating Inventory** -   
  + Assumes that a continuing relationship exists between \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. Based on experience in previous \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, a gross profit to net sales percentage is calculated.

**Retail Method of Estimating Inventory**

* **Retail Method of Estimating Inventory** -   
  + To use the retail method, a business must keep separate records of both \_\_\_\_\_\_\_\_\_\_\_\_ and \_\_\_\_\_\_\_\_\_\_\_\_\_ prices for net purchases, net sales, and beginning merchandise inventory.

**Merchandise Inventory Turnover**

* The more \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ a business sells merchandise, the more chance it has to make a satisfactory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_. Two measures of the speed with which merchandise inventory is sold are:

1. Merchandise inventory \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ ratio.
2. Average number of days’ \_\_\_\_\_\_\_\_\_\_\_\_\_\_ in merchandise inventory.

*Merchandise Inventory Turnover Ratio*

* **Merchandise Inventory Turnover Ratio** -   
  + Expresses a relationship between an \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ inventory and the \_\_\_\_\_\_\_\_\_\_\_\_ of merchandise sold.
  + A low merchandise inventory turnover ratio indicates a \_\_\_\_\_\_\_\_\_\_\_\_\_\_ return on investment.
  + The ratio is compared with other ratios published by national trade associations.
  + Merchandise inventory turnover ratio calculation:

Step 1: January 1 December 31 Average

Merchandise + Merchandise ÷ 2 = Merchandise

Inventory Inventory Inventory

Step 2: Cost of ÷ Average Merchandise = Merchandise Inventory

Merchandise Sold Inventory Turnover Ratio

*Average Number of Days’ Sales in Merchandise Inventory*

* **Average Number of Days’ Sales in Merchandise Inventory** -   
  + An average number of 70 days, for example, means that, on average, each item in merchandise inventory is sold 70 days after it is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.
  + The average number of days is compared with other averages published by national trade associations.
  + Average Number of Days’ Sales in Merchandise Inventory calculation:

Merchandise Average Number of

Days in Year ÷ Inventory = Days’ Sales in

Turnover Ratio Merchandise Inventory

**Practice Problem**

*The following information is available for Handy Hardware for the month of April. Estimated merchandise inventory sheets are provided below.*

**Cost Retail**

Beginning Inventory, April 1 $124,850 $193,400

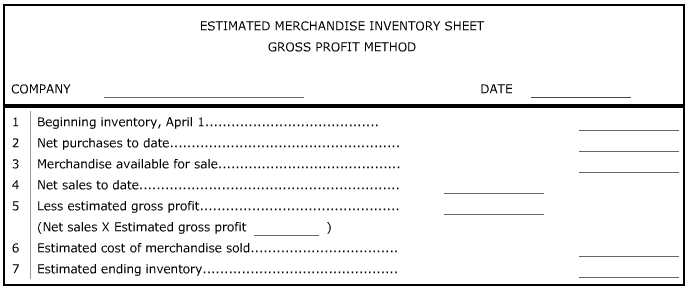
Net Purchases 73,230 110,340

Net Sales 138,500

Gross Profit Percentage: 37%

Percentage of merchandise available for sale at cost to merchandise available at retail: 65.2%

1. Estimate the ending inventory using the gross profit method.



1. Estimate the ending inventory using the retail method.

