WEEK 2 – Inventories

Merchandising Business:

- Merchandising businesses buy and resell inventory.
- Operating cycle longer than service business… Buy inventory -> Sell inventory -> Invoice customers -> Receive cash
- Revenues are referred to as **sales revenue**.
- Expenses are divided into 2 categories:
    - **cost of sales**: directly related to the sales.
    - **operating expense**: all other costs of the business.
- GROSS PROFIT = SALES REVENUE – COST OF SALES
- NET PROFIT (LOSS) = GROSS PROFIT – OPERATING EXPENSES

Service Business:

- Operating cycle shorter than in a merchandising business… Perform services -> Invoice customers -> Receive cash.

Perpetual Inventory System:

- Inventory system where the cost of inventory is maintained.
- Records continuously show the inventory that should be on hand (car dealership, furniture stores…)
- Use of bar codes and optical scanners has led to wide use (supermarkets, retail…)
- Record purchase of inventory when inventory is purchased. Record revenue and cost of sales when item is sold. No further calculations needed at end of period.
- **To record sale of inventory:**
    - 2 entries are required. 1st to record the sale of goods. 2nd to record the cost of sales.
        - 1st transaction. Dr Cash, Cr Sales. (or) Dr Accounts receivable, Cr Sales.
        - 2nd transaction. Dr Cost of sales, Cr Inventory.
- **To record returns/allowances:**
    - 2 entries are required. 1st to record sales return at selling price. 2nd to record return to inventory at cost price.
        - 1st transaction. Dr Sales returns and allowances (this is a contra [means reduce sales revenue] revenue account), Cr Accounts receivable/Cash.
        - 2nd transaction. Dr Inventory, Cr Cost of sales. (or, if we cannot resell the item) Dr Inventory write-down, Cr Cost of sales.
- NET SALES = SALES – SALES RETURNS AND ALLOWANCES
- GROSS PROFIT = NET SALES – COST OF SALES

Periodic Inventory System:

- Inventory system where detailed records are not maintained.
- Cost of sales is determined only at the end of accounting period by a physical inventory account.
- Used widely in small business (cafes, convenience stores…).
- Record purchase of inventory when inventory is purchased. Record revenue when item is sold. Calculate cost of sales at end of period (via stocktake).

Purchase Returns and Allowances

- Purchase return is the return of goods by the customer. Customer will receive a refund in the form of cash or credit.

WEEK 3 – Reporting and Analysing Inventory

Classifying Inventory: For manufacturing business, inventories are normally classified into 3 categories; raw materials (will be used but not in production yet), work in process (inventories that has started to be manufactured but is incomplete) and finished goods (ready for sale).

Periodic Inventory System: Revenue is recorded when sale is made. Cost of sales is not recorded at this time. The quantity on hand & cost of sales are only determined by physical count at the end of the period.

Purchased of Inventory: Purchases account is used to record cost of all inventory purchased. (Dr Purchases, Cr Accounts Payable)

Purchases returns and allowances: Only 1 transaction is recorded at time of sale (Dr Accounts Payable, Cr Purchase Returns and Allowances).

Freight costs: Freight costs incurred by purchaser are expenses (Dr Freight-in, Cr Cash).

Purchase discounts: Same as perpetual system, (Dr Accounts Payable, Cr Cash & Cr Discount Received). Discount received is a revenue account.

Sale of inventory: Unlike perpetual system, we only record one transaction and leave the reconciliation of inventory numbers until the end of the period. (Dr Accounts Receivable, Cr Sales)

Sales returns and allowances: Again, unlike perpetual system, we only record one transaction. (Dr Sales Returns and Allowances, Cr Accounts Receivable/Cash)

Sales discounts: Same as perpetual system (Dr Cash, Cr Discount Allowed & Cr Accounts Receivable)

Cost of goods purchased:

	Purchases	$ 325 000
(1)	Less: Purchase returns and allowances	(17 200)
	Net purchases	307 800
(2)	Add: Freight-in	12 200
	Cost of goods purchased	$320 000

Determining inventory quantities: Inventory on hand is determined by physical count. If goods are on transit, there are two ways for ownership to be determined: FOB (free on board) shipping point the buyer becomes the owner when the goods are accepted by the freight entity, or FOB destination ownership remains by with the seller until the goods reach the buyer.

Cost of sales:

	Beginning inventory	$ 36 000
(1)	Add: Cost of goods purchased	320 000
	Cost of goods available for sale	356 000
(2)	Less: Ending inventory	(40 000)
	Cost of sales	$316 000

PW AUDIO SUPPLY LTD
Statement of profit or loss
for the year ended 30 June 2017

Sales revenue			
Gross sales revenue			$ 480 000
Less: Sales returns and allowances			(20 000)
Net sales			460 000
Cost of sales			
Inventory, 1 July 2016		$ 36 000	
Purchases	$325 000		
Less: Purchase returns and allowances	(17 200)		
Net purchases	307 800		
Add: Freight-in	12 200		
Cost of goods purchased		320 000	
Cost of goods available for sale		356 000	
Inventory, 30 June 2017		40 000	
Cost of sales			(316 000)
Gross profit			144 000
Other operating revenue			24 000
			168 000
Operating expenses			(125 000)
Profit before income tax			43 000
Less: Income tax expense			(12 900)
Profit after income tax			$ 30 100

The cost of sales section in the statement of profit or loss differs depending on whether the periodic or perpetual system were used (more detail [like here ←] is needed for periodic). However, for the statement of financial position, the cost of sales section is the same.

Specific identification: Only possible when a business sells a limited range of high unit cost items that can be clearly identified from the time of purchase to the time of sale (car dealership, jewellery store…).

Cost flow assumptions: There are 3 possible methods to deal with cost flow:

1. **FIFO (First-in, first-out)**: First goods purchased are first sold.
2. **LIFO (Last-in, first-out):** Last goods purchased are first sold.
3. **Average cost:** Assumes goods sold are similar and therefore a weighted average can be used to calculate cost.

These methods have effects on the statement of profit or loss; in times of increasing prices, FIFO reports highest profit, average costs middle & LIFO lowest profit. Opposite is true for periods of decreasing prices.

They also effect the statement of financial position. In a period of increasing prices, costs allocated to ending inventory using FIFO will approximate current costs whereas LIFO will understate these costs.

In times of rising prices, (inflation…) LIFO will give lower profit and therefore lower taxes. However, LIFO is not allowed in Australia or NZ.

Most importantly, is that whichever method is used should be used <u>consistently</u> so that statements are comparable. When a firm chooses to change methods, it must disclose the change in the financial statements as well as the effect the change will have on profits.

Lower of cost and net realisable (LCNRV): When the value of inventory is lower than its cost, the inventory is written down to its market value by valuing the inventory at LCNRV in the period where the price decline occurs.

Net realisable value (NRV): the estimated proceeds of sale less costs incurred in completing sale.

<u>**Perpetual Inventory System:**</u> Revenue and cost of sales are recorded at time of sale.

Inventory is constantly accounted for, example below for FIFO:

Date	Purchases	Sales	Balance
Jan. 1			(100 @ $10) $1000
Apr. 15	(200 @ $11) $2200		(100 @ $10) (200 @ $11) $3200
Aug. 24	(300 @ $12) $3600		(100 @ $10) (200 @ $11) (300 @ $12) $6800
Sept. 10		(100 @ $10) (200 @ $11) (250 @ $12) $6200	(50 @ $12) $ 600
Nov. 27	(400 @ $13) $5200		(50 @ $12) (400 @ $13) $5800

Errors in Inventory:

If beginning inventory is understated: Cost of sales will be understated and therefore, profit will be overstated. Opposite is also true.

If ending inventory is understated: Cost of sales will be overstated, profit will be understated. Therefore, assets will be understated and equity is also understated.

Closing entries for merchandising firms: At the end of a period there are certain accounts that must be closed; including sales returns and allowances and cost of sales.

The Committee of Sponsoring Organisations (COSO) Treadway Committee Report:
Three Internal Control Objectives:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.

Five Internal Control Components

- Control Environment
  - Sets the tone for the organisation from top management
- Risk Assessment
  - Identify risk, assess possible impacts and prepare action plans
    - Identify risks by checking the Financial Statements – Financial statements are asserted by the preparer
      - Assertions:
        - Occurrence
        - Completeness
        - Accuracy
        - Cut-off
        - Classification
- Control Activities
  - Response on risks identified from management
- Information and Communication
  - Design of the information systems
  - Assign responsibilities to staff members - leads to accountability
- Monitoring
  - Consistent evaluations

IDENTIFYING RISKS

Assertion	Explanation	Risk	Example of Risk	Control Focus
TRANSACSTIONS				
OCCURRENCE	All transactions included in the financial statements have occurred.	Transactions may be entered that have not occurred.	Sales entered that have not occurred.	Processes to verify that transactions have taken place before being recorded.
COMPLETENESS	All transactions and events that should have been recorded have been recorded.	Transactions may have been omitted	Sales occurring but not recorded.	Process to check for missing transactions or events.
ACCURACY	Data relating to transactions and events have been correctly recorded.	Data entry errors may misrepresent the effect of the event and materially misstate the financial statements.	Entering data incorrectly	Processes in place to check data as it enters the accounting system.