

# CHAPTER 6

## Reporting and Analyzing Inventory

### ANSWERS TO QUESTIONS

1. Agree. Effective inventory management is frequently the key to successful business operations. Management attempts to maintain sufficient quantities and types of goods to meet expected customer demand. It also seeks to avoid the cost of carrying inventories that are clearly in excess of anticipated sales.
2. Inventory items have two common characteristics: (1) they are owned by the company and (2) they are intended to be sold to customers in the ordinary course of business.
3. Just-in-time inventory management is the practice of manufacturing or purchasing inventory “just-in-time” to fill a sales order. Since inventory quantities are kept at very low amounts, just-in-time management reduces the costs associated with carrying inventory as well as the risk of obsolescence.
4. Taking a physical inventory involves actually counting, weighing, or measuring each kind of inventory on hand. Retailers, such as hardware stores, generally have thousands of different items to count. This is normally done when the store is closed. Jill will probably count items and mark the quantity, description, and inventory number on prenumbered inventory tags.
5. (a) (1) The goods will be included in Millar Company’s inventory if the terms of sale are FOB destination.  
(2) The goods will be included in Branyan Corporation’s inventory if the terms of sale are FOB shipping point.  
  
(b) Millar Company should include goods shipped to a consignee in its inventory. Goods held by Millar Company on consignment should not be included in inventory.
6. Inventoriable costs are \$3,015 (invoice cost \$3,000 + freight charges \$75 – purchase discounts \$60).
7. The primary basis of accounting for inventories is cost in accordance with the historical cost principle. The major objective of accounting for inventories is the proper determination of net income in accordance with the expense recognition principle.
8. Actual physical flow may be impractical because many items are indistinguishable from one another. Actual physical flow may be inappropriate because management may be able to manipulate net income through specific identification of items sold.
9. The major advantage of the specific identification method is that it tracks the actual physical flow of the goods available for sale. The major disadvantage is that management could manipulate net income.
10. No. Selection of an inventory costing method is a management decision. However, once a method has been chosen, it should be consistently applied.
11. (a) FIFO, (b) Average-cost, (c) LIFO.

## Questions Chapter 6 (Continued)

12. Long Company is using the FIFO method of inventory costing, and Windsor Company is using the LIFO method. Under FIFO, the latest goods purchased remain in inventory. Thus, the inventory on the balance sheet should be close to current costs. The reverse is true of the LIFO method. Long Company will have the higher gross profit because cost of goods sold will include a higher proportion of goods purchased at earlier (lower) costs.
13. Espinosa Corporation may experience severe cash shortages if this policy continues. All of its net income is being paid out as dividends, yet some of the earnings must be reinvested in inventory to maintain inventory levels. Some earnings must be reinvested because net income is computed with cost of goods sold based on older, lower costs while the inventory must be replaced at current, higher costs. Because of this factor, net income under FIFO is sometimes referred to as including "phantom profits." In addition, Espinosa is also depleting cash more quickly under FIFO because FIFO results in higher income tax payments.
14. George is partially correct. In a period of inflation, FIFO produces higher net income because the lower unit costs of the first units purchased is matched against revenues. A switch from LIFO to FIFO will thus produce higher net income and a larger bonus for George, which he perceives as being "better off". It is more difficult to determine if the company would be "better off" if it used FIFO instead of LIFO. Using FIFO would mean higher reported income and higher inventory values which investors usually interpret as "better" results. On the other hand, the higher net income reported with FIFO would mean higher bonus and income tax expenses. Since both of these items require cash, switching to FIFO may leave the company with an inadequate amount of cash to meet normal operating needs.
15. When prices are increasing, LIFO results in higher cost of goods sold, and lower income relative to FIFO. Because LIFO income is lower the company pays lower taxes, which results in higher cash flows. The quality of earnings ratio is net cash provided by operating activities divided by income. The use of LIFO will increase the numerator (net cash provided by operating activities) and decrease the denominator (net income), both of which increase the value of the ratio.
16. Tootsie Roll uses LIFO for U.S. inventories and FIFO for foreign inventories. LIFO is not allowed in most countries outside the U.S., therefore Tootsie Roll uses a different method for foreign inventories.
17. Alison should know the following:
  - (a) A departure from the cost basis of accounting for inventories is justified when the value of the goods is no longer as great as its cost. The writedown to market should be recognized in the period in which the price decline occurs.
  - (b) Market means current replacement cost, not selling price. For a merchandising company, market is the cost at the present time from the usual suppliers in the usual quantities.
18. Rondeli Music Center should report the TVs at \$350 each for a total of \$1,750. \$350 is the current replacement cost under the lower-of-cost-or-market (LCM) basis of accounting for inventories. A decline in replacement cost usually leads to a decline in the selling price of the item. Valuation at LCM is conservative.
19. Lower-of-cost-or-market can be applied after any of the cost flow assumptions has been used, including LIFO, FIFO, average-cost, or specific identification.
20. Freight-out expense is not a cost associated with purchasing goods, so it should not affect cost of goods sold. It is an expense incurred to sell goods already purchased, so it should be reported as a selling expense.

## Questions Chapter 6 (Continued)

21. Dipoto Company should disclose (1) the major inventory classifications, (2) the basis of accounting (cost or lower-of-cost-or-market), and (3) the costing method (FIFO, LIFO, or average).
22. An inventory turnover that is too high may indicate that the company is losing sales opportunities because of inventory shortages. Inventory outages may also cause customer ill will and result in lost future sales.
23. The LIFO reserve is a required disclosure for companies that employ LIFO. It is the difference between ending inventory using LIFO and ending inventory if FIFO were used instead. Ignoring a large LIFO reserve when analyzing a company can distort any comparisons that an analyst might try to make with a company's competitors that used FIFO.
- \*24. Disagree. The results under the FIFO method are the same but the results under the LIFO method may be different. The reason is that the pool of inventoriable costs (costs of goods available for sale) is not the same. Under a periodic system, the pool of costs is the goods available for sale for the entire period, whereas under a perpetual system, the pool is the goods available for sale up to the date of sale.
- \*25. In a perpetual inventory system, the average is a moving average of goods available for sale after each purchase. In a periodic inventory system, the average is a weighted average based on total goods available for sale for the period.
- \*26. (a) Marshall Company's 2013 net income will be understated \$5,000; (b) 2014 net income will be overstated \$5,000; and (c) the combined net income for the two years will be correct.