

Week 2 - DQ 1

Under what circumstances would a company need to estimate its inventory?

What are the differences between using the gross profit method and retail inventory method for estimating inventory?

Which method of estimation, gross profit or retail inventory, is best? Explain your answer.

Response #1 A company would need to estimate their inventory if a large theft incident occurred or some type of disaster suddenly happened. The difference between using the gross profit method and retail inventory method for estimating an inventory is the retail method uses a formula of the current retail prices to convert to cost. The gross profit method estimates an inventory by using the previous year's average gross profit margin. The gross profit is calculated by sales minus the cost of goods divided by sales. It would depend on the company as far as the gross profit or retail method of estimation for inventory that would be the best. However I would say the retail method is more reliable because the gross profit method is calculated from the previous year which may not be the gross margin for the current period when the inventory is estimated.

Response #2 A company might need to estimate its inventory after natural disasters or increased thefts. If the company needs to produce financial statements before the normal period of which they would present them, the company may estimate its inventory.

One of the most prominent differences between the gross profit and the retail inventory methods is that the former relies on historical data and the latter relies on data from the most recent period.

The best method is dependent upon the company. When I worked in a gravel pit we would generally use the gross profit method because our costs were fairly consistent. Another company may have a retail aspect and need to estimate the inventory using the retail inventory method.

Response #3 An estimated inventory is performed when a physical inventory is impractical or impossible. This does not happen with perpetual inventories because this type of inventory will always have current inventories, however, periodic inventories will need to use the estimation methods. When a company performs estimated inventory it would have two methods to choose from; the retail and the gross profit inventory. Retail inventory tracks cost and retail sales price of inventory. Gross profit inventory estimates the value of inventory by applying the company's historical gross profit percentage to current-period information about net sales and cost of goods sold. The best method of estimation would depend on the type of company. Larger companies may find the gross profit method easier to use. Retail business would do better with the retail methods because they can separate their inventories.

Response #4 A company would need to estimate its inventory when taking a physical inventory is considered impractical. Perhaps interim reports are needed and its not yet time for the annual count. Companies may also estimate inventory when inventory or inventory records are destroyed by a fire or other type of catastrophe. There are differences between using the gross profit method and the retail inventory method when estimating inventory. The gross profit method relies on historical records. The necessary information comes from the financial records of the current period, except for gross profit percentage, which is determined with a review of prior records and company policies. The current rate is more appropriate than historical costs. The retail inventory method uses a formula to convert retail prices to cost. To do this, the retailer has to keep records of the total cost and retail value of purchased goods, the period's sales, and the total cost and retail value of goods that are available for sale.

It would seem to depend on the company whether the gross profit method is better than the retail inventory method, but the gross profit method seems to have an important disadvantage. That method uses past percentages, not the current rate. If a company uses this method to determine ending inventory for a report, GAAP requires a mention that this method was used. The retail inventory method offers a much quicker and more reliable way to measure inventory. If an interim report is needed, it's not as much of a problem as the gross profit method. The retail method doesn't require a physical inventory count to determine net income, though some companies may still choose to do one. It is also handy as a control measure regarding shortages in inventory and can be used by insurance adjusters for estimating losses. I can see where both gross profit and retail methods can be useful depending on the line of work a company is in, but I think retail inventory may be best because of its speed, reliability, and the various reasons a company would choose to use that method.

Reference: Kieso, D.E., Weygandt, J.J., & Warfield, T.D. (2007). *Intermediate Accounting* (12th ed.). Hoboken, NJ: John Wiley & Sons.