Inventory

Part 4

Your goals for this "Inventory" chapter are to learn about:

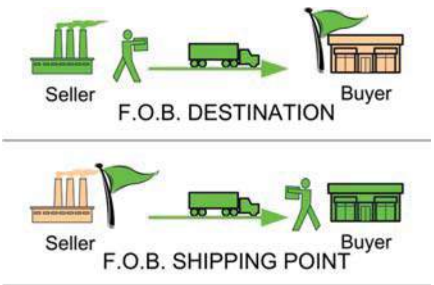
- The correct components to include in inventory.
- Inventory costing methods, including specific identification, FIFO, LIFO, and weighted-average techniques.
- The perpetual system for valuing inventory.
- Lower-of-cost-or-market inventory valuation adjustments.
- Two inventory estimation techniques: the gross profit and retail methods.
- Inventory management and monitoring methods, including the inventory turnover ratio.
- The impact of inventory errors.

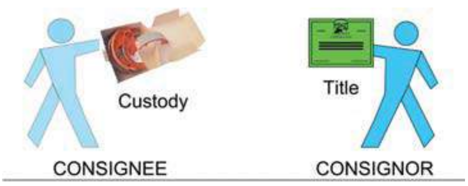
15. The Components of Inventory

You have already seen that inventory for a merchandising business consists of the goods available for resale to customers. However, retailers are not the only businesses that maintain inventory. Manufacturers also have inventories related to the goods they produce. Goods completed and awaiting sale are termed “finished goods” inventory. A manufacturer may also have “work in process” inventory consisting of goods being manufactured but not yet completed. And, a third category of inventory is “raw material,” consisting of goods to be used in the manufacture of products. Inventories are typically classified as current assets on the balance sheet. A substantial portion of the managerial accounting chapters of this book deal with issues relating to accounting for costs of manufactured inventory. For now, we will focus on general principles of inventory accounting that are applicable to most all enterprises.

15.1 Determining Which Goods to Include in Inventory

Recall from the merchandising chapter the discussion of freight charges. In that chapter, F.O.B. terms were introduced, and the focus was on which party would bear the cost of freight. But, F.O.B. terms also determine when goods are (or are not) included in inventory. Technically, goods in transit belong to the party holding legal ownership. Ownership depends on the F.O.B. terms. Goods sold F.O.B. destination do not belong to the purchaser until they arrive at their final destination. Goods sold F.O.B. shipping point become property of the purchaser once shipped by the seller. Therefore, when determining the amount of inventory owned at year end, goods in transit must be considered in light of the F.O.B. terms. In the case of F.O.B. shipping point, for instance, a buyer would need to include as inventory the goods that are being transported but not yet received. The diagram at right is meant to show who includes goods in transit, with ownership shifting at the F.O.B. point noted with a “flag.”





CONSIGNED GOODS BELONG IN THE INVENTORY OF THE CONSIGNOR

Another problem area pertains to goods on consignment. Consigned goods describe products that are in the custody of one party, but belong to another. Thus, the party holding physical possession is not the legal owner. The person with physical possession is known as the consignee. The consignee is responsible for taking care of the goods and trying to sell them to an end customer. In essence, the consignee is acting as a sales agent. The consignor is the party holding legal ownership/title to the consigned goods in inventory. Because consigned goods belong to the consignor, they should be included in the inventory of the consignor -- not the consignee!

Consignments arise when the owner desires to place inventory in the hands of a sales agent, but the sales agent does not want to pay for those goods unless the agent is able to sell them to an end customer. For example, auto part manufacturers may produce many types of parts that are very specialized and expensive, such as braking systems. A retail auto parts store may not be able to afford to stock every variety. In addition, there is the real risk of ending up with numerous obsolete units. But, the manufacturer desperately needs these units in the retail channel -- when brakes fail, customers will go to the source that can provide an immediate solution. As a result, the manufacturer may consign the units to auto parts retailers.

Conceptually, it is fairly simple to understand the accounting for consigned goods. Practically, they pose a recordkeeping challenge. When examining a company’s inventory on hand, special care must be taken to identify both goods consigned out to others (which are to be included in inventory) and goods consigned in (which are not to be included in inventory). Obviously, if the consignee does sell the consigned goods to an end user, the consignee would keep a portion of the sales price, and remit the balance to the consignor. All of this activity requires a good accounting system to be able to identify which units are consigned, track their movement, and know when they are actually sold or returned.