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Theoretical lesson nº 10

Chapter 6

Reporting and Interpreting Cost of Goods Sold and Inventory

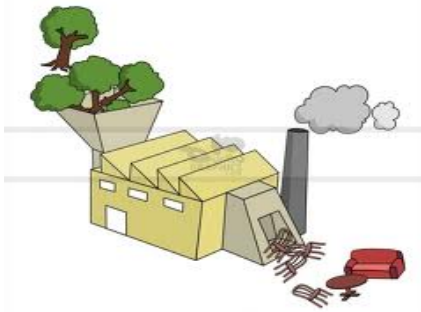
In the end of this chapter you should…

- ✓ Apply the cost principle to identify the amounts that should be included in inventory and the matching principle to compare revenues with expenses for determine cost of goods sold **(page 369)**;
- ✓ Report inventory and cost of goods sold using different inventory costing methods. **(page 374)**;
- ✓ Analyse the financial effects of different inventory costing methods **(page 379)**;
- ✓ Report inventory at the lower of cost of market **(page 382)**;
- ✓ Compare companies that use different inventory costing methods. **(Page 389)**.

Definition and type of inventories

Inventories are

Assets



Held for sale during the operational activity

- Merchandise/Goods
- Finished Goods

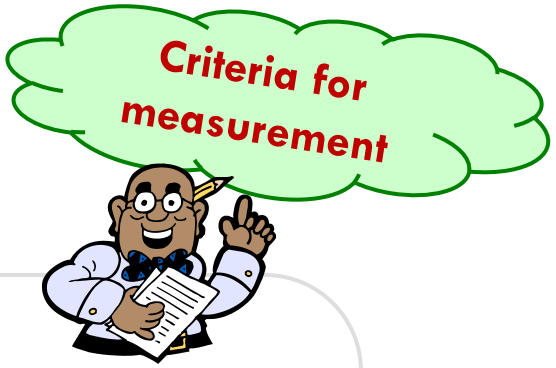
Under work in process

Work in Process Inventory

Held for use and consume during the production process or during services rendered

- Raw materials

Measurement of inventories



General rule: Cost

Exception: Net realisable value (when lower than cost)

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Measurement of inventories

Inventories

Cost: 10.000

Net realisable value = 12.000

Mantain the cost of the invesntories

Net realisable value = 9.000

Recognize a loss of 1.000

Decrease the amount of inventories (Balance sheet)

Impairment loss (income statement)

Measurement of inventories

Commercial companies

Acquisition of merchandises → **Warehouse of merchandises** → **Outflow of merchandises (for sale)**

Cost of merchandise = Acquisition cost

- purchase price
- import duties and non-recoverable taxes
- transportation costs and handling
- other costs incurred to bring the goods to its place and in its current condition
- Reduced by trade discounts and allowances

Measurement of inventories

Industrial companies

Acquisition of raw materials → **Warehouse of Raw materials** → **Outflow of Raw materials (for consume)**

Cost of raw materials = Acquisition cost

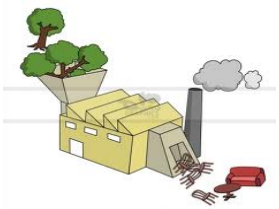
- purchase price
- import duties and non-recoverable taxes
- transportation costs and handling
- other costs incurred to bring the goods to its place and in its current condition
- Reduced by trade discounts and allowances

Measurement of inventories

Industrial companies

Consume of raw materials → **Transformation process** → **Finished goods warehouse** → **Outflow of Finished goods (for venda)**

Cost of finished goods = Consume of raw materials
MP
+
Conversion costs



Outflow of inventories

Commercial companies

Initial Balance

Merchandises on hand at the beginning of the period

\+

Acquisition of merchandises

=

Cost of goods sold (CGSCM)

\+

Final Balance

Merchandises on hand at the end of the period

CGS = Merchandises at the beggining + Acquisitions of merchandises – Merchandises at the end

Outflow of inventories

Industrial companies

Initial Balance

Raw materials on hand at the beginning of the period

\+

Acquisition of raw materials

=

Cost of consumed materials (CGSCM)

\+

Final Balance

Raw materials on hand at the end of the period

CCM = raw materials at the beggining + Acquisitions of raw materials – raw materials at the end

Outflow of inventories

Industrial companies

Initial balance

Finished goods on hand at the beginning of the period

\+

Production cost (raw materials and conversion cost)

Income statement

=

Cost of goods sold (CPS)

\+

Finished goods on hand at the end of the period

Final balance

CPS = Production cost + Finished goods at the beggining of the period – + Finished goods at the end of the period

CPS = Production cost - Δ Production

Costing methods for measure the outflow of inventories

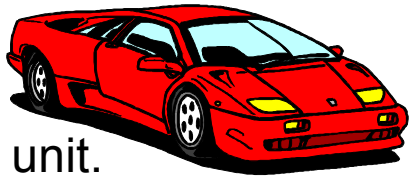
Costing methods for measure the ouflow of inventories after each sale or consumption:

1. Specific Identification → Unique products
2. FIFO (first-in-first-out)
3. LIFO (last-in-first-out)
4. Average Cost

→ standard products

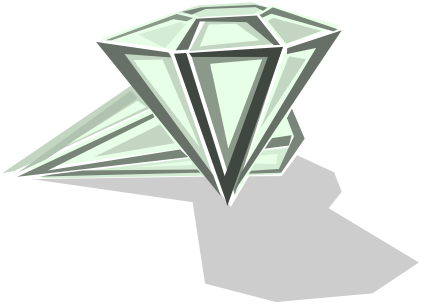
The costing methof do not correspond to the fisic outflow from the warehouse.

Specific Cost



CGSCM corresponds to the specific cost of each sold unit.

Examples:
Jewelry luxury
ships, trains, bridges, luxury cars

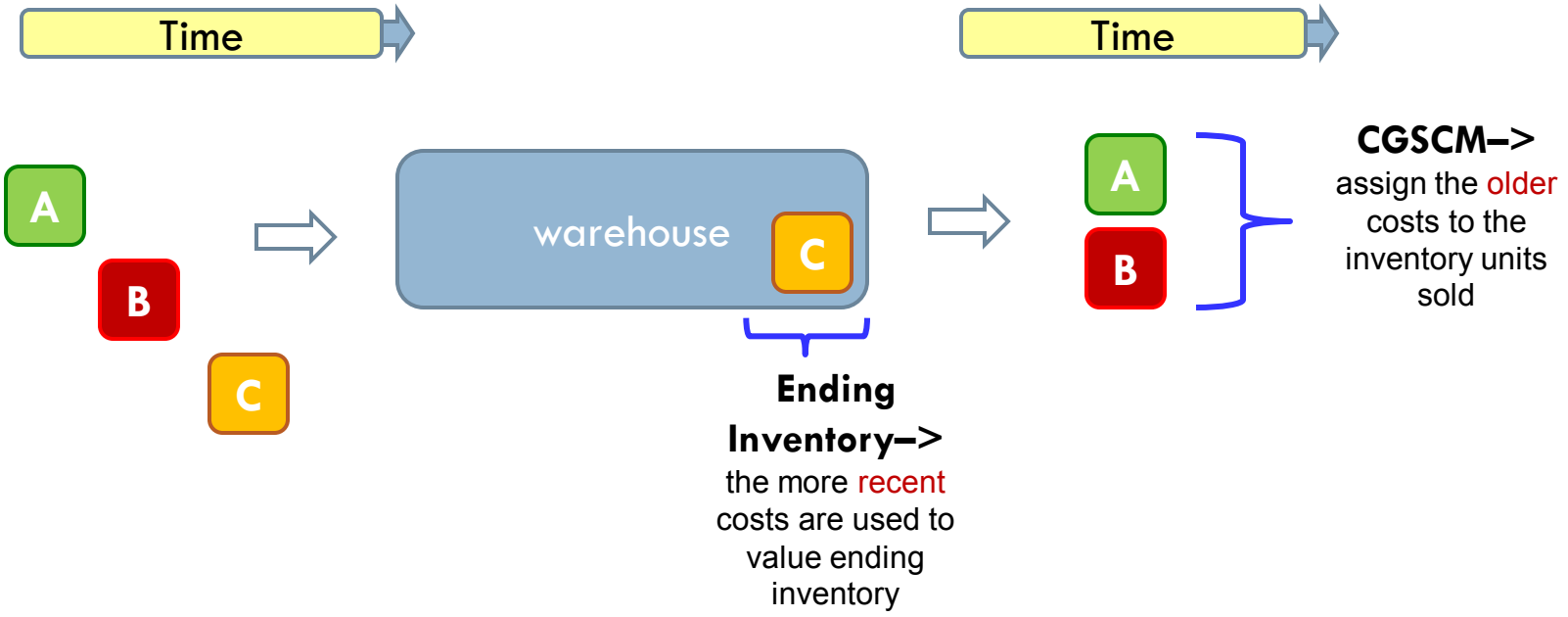


Costing methods for measure the outflow (exit) of inventories

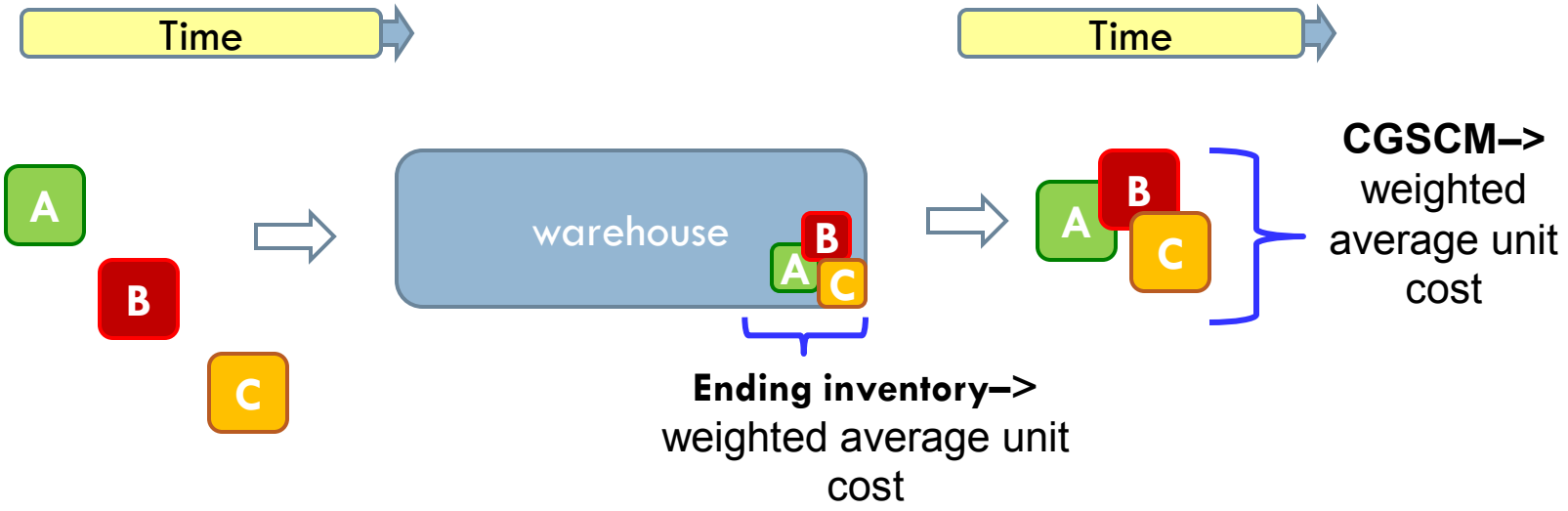
FIFO

first goods purchased (the first in)

are the first goods sold (first out).



Weighted Average Cost Method



The average cost is determined by dividing the cost of goods available for sale by the number of units available for sale. The average cost method uses the weighted average unit cost of the goods available for sale for both cost of goods sold and ending inventory.

Costing methods for measure the outflow (exit) of inventories

FIFO versus CMP

In an economic scenario with inflation, prices for acquisition of goods and materials are increasing

	FIFO	WAC
CGSCM (Income Statement)	Lower(<)	Higher(>)
Inventories on hand at the end (Balance Sheet)	Higher(>)	Lower(<)

Costing methods for measure the outflow (exit) of inventories

Managers decide which method is most suitable for business

The choice of valuation method for measure the outputs (inventories) has effects on income and taxes payable

Managers may prefer to pay less tax

Choose the method that results in higher CGSCM

Managers may prefer to have better (immediate) results

Choose the method that results in lower CGSCM

Perpetual Inventory Systems

- ✓ CGSCM is calculated and recorded after each sale.
- ✓ The Inventories on hand are updated after each sale.

Periodic Inventory Systems

- ✓ CGSCM is calculated and recorded just at the end of the period.
- ✓ The Inventories on hand are updated just at the end of the period.

Inventory Systems

	Perpetual Inventory Systems	Periodic Inventory Systems
Merchandises/raw materials on hand at the beggining of the period	Amount in the balance sheet of N-1 Beginning balance of inventories	Amount in the balance sheet of N-1 Beginning balance of inventories
+ Acquisitions	Total amount of acquisition in N	Total amount of acquisition in N
- Merchandises/raw materials on hand at the end of the period	Balance of the account merchandises/raw materials, that are allways updated	Value obtained at the end of N by physical count and measurement of inventories
= CGSCM	Recognized in each sales / warehouse exit	Recognized at the end of the period for full (total) value

End of chapter 6