I. Review and Introduction
   A. Inventory consists of all goods held for sale in the regular course of business

   B. Inventory is a nonmonetary asset
      1. Definition of monetary assets
      2. Unexpired cost that will become an expense in period which is benefitted

   C. Internal Control Measures
      1. Safeguard the asset
      2. Proper recording and reporting

   D. Measurement of Ending Inventory
      1. Physical count to determine quantity
         a. Watch for goods in transit
         b. Consigned goods

      2. Multiply cost by quantity
         a. Cost includes purchase price plus any charges in getting inventory ready for sale

      3. Measurement errors affect both the balance sheet and income statement
         a. COGS, Inventory, Owner's capital
         b. Errors are self correcting
            (1) Because ending inventory of year 1 becomes beginning inventory of year 2
         c. Use COGS formula to evaluate errors

II. Cost Flow Assumptions
    A. Relates to assignment of costs, not necessarily the physical flow of goods
       1. Important due to changing prices

    B. There are several generally accepted methods
       1. Illustration of methods:

<table>
<thead>
<tr>
<th></th>
<th>Quant</th>
<th>Price</th>
<th>Total $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beg. Inventory</td>
<td>5</td>
<td>$10</td>
<td>$ 50</td>
</tr>
<tr>
<td>Purchase #1</td>
<td>10</td>
<td>12</td>
<td>120</td>
</tr>
<tr>
<td>Purchase #2</td>
<td>8</td>
<td>15</td>
<td>120</td>
</tr>
<tr>
<td>Purchase #3</td>
<td>3</td>
<td>20</td>
<td>60</td>
</tr>
<tr>
<td>Total Avail.</td>
<td>26</td>
<td></td>
<td>$350</td>
</tr>
</tbody>
</table>

Physical count shows we have 10 units left.
a. Specific identification -- ending inventory can be identified as having come from specific purchases. Cost of each specific item is tracked.
   Makeup of End Inv:
   4 from 1st purchase
   4 from 2nd purchase
   2 from 3rd purchase

b. Illustrating using Periodic Inventory System
   (1) Weighted average cost (avg cost) -- calculates a weighted average per unit cost on goods available for sale

   Cost of Goods Available
   Units of Goods Available

   (2) First-in, First-out (FIFO) -- Cost of oldest items to goods sold. So ending inventory is costed at prices of most recent purchases.

   (3) Last-in, First-out (LIFO) -- Cost of most recent items purchased assigned to items sold. Therefore, ending inventory is assumed to consist of items from earliest purchases.

C. Comparison of methods
   1. Specific identification offers potential for manipulation of net income

   2. Weighted Average Method -- will result in valuations between FIFO and LIFO. Tends to average out price changes. Price movements are not as apparent.

   3. FIFO -- Newest costs to ending inventory. Ending inventory most closely approximates replacement cost. Highest net income when prices are rising.

   4. LIFO -- Oldest costs to ending inventory. Better matching of current cost with revenues. Tax advantages when prices are rising.

D. Must disclose method(s) used in financial statements

III. Perpetual Inventory Systems
A. Cost flow assumptions are applied at the time of each sale

B. FIFO--will yield the exact same results as Periodic system

C. LIFO--cost of the units “last-in” is determined at the time of each sale.

D. Moving Weighted Average-- a new unit cost is determined at the time of a new purchase is made.

\[
\frac{\text{\$ Goods available for sale}}{\text{Units available for sale}} = \text{average cost}
\]
IV. Lower of cost or market rules
   A. Application of the concept of conservatism
   B. What is cost??
   C. Market generally equals replacement cost
   D. Alternative methods of applying LCM

V. Inventory Estimation Techniques
   A. Gross profit method
      1. **MAJOR ASSUMPTION** – stable gross profit percentage
      2. Useful for interim statements and when inventory is destroyed by fire or other casualty
      3. Mechanics
         a. Compute goods available for sale (BI plus cost of goods purchased)
         b. Compute estimated COGS (Sales X Cost %)
         c. Subtract b) from a) to estimate ending inventory
   B. Retail method
      1. Based on the relationship between cost and sales price of inventory items
      2. Mechanics
         a. Find goods available at cost and at retail
         b. Compute cost to retail (ratio)
         Goods Available at cost
         Goods Available at retail
         c. Multiply ending inventory at retail by cost to retail ratio
            (1) Based on physical count priced at retail
            (2) Goods available for sale at retail - Sales = Ending inventory at retail

VI. Financial Analysis and Interpretation
   A. Evaluation of effectiveness and efficiency of inventory management
      1. Inventory Turnover
         
         COGS
         -------------------------------
         Average inventory
         
         2. Number of days sales in inventory
         
         Ending Inventory
         ------------------------------- Or 365
         Average daily COGS
         
         Or
         Inventory Turnover