CONTENTS

LOWER OF COST & NET REALISABLE VALUE

- It is usual for the cost price of the inventory to be less than its selling price, so recording it in the inventory cards at its original purchase price (which is required by the Qualitative Characteristic – **Verifiability**) also means the inventory is not overstated (which is the goal of the Qualitative Characteristic – **Faithful Representation**).

- When the selling price of the inventory falls below the cost price it is probable that a loss will occur instead of generating a profit on the sale.

- Continuing to value inventory at its cost price would mean that we are not presenting information that is free from material error: Assets would be overstated as would Owner’s Equity as we not recoding the probable loss on sale.

The Accrual Basis Assumption states that expenses should be recognised when the consumption of goods can be recognised. Accordingly, as we need to record the anticipated loss in the period when the selling price falls below cost price.

Inventory is **always** recorded at Cost unless there are circumstances that have caused the inventory to be valued at lower than cost price and a loss will result.

Possible Reasons:

- Damaged Inventory.
- Seasonal market movements.
- Obsolete or out of date inventory.
- Lack of demand for product.
- Deliberate marketing strategy.

Net Realisable Value is the **ESTIMATED** selling price of a product, **LESS** any cost incurred in marketing, selling and distributing the items.

INVENTORY IS VALUED AT THE LOWER FIGURE

- If **cost** is **lower** than **NRV** you continue to use cost price as recorded on the inventory cards – **no entry required**.

- If **NRV** is **lower** than **cost** you must **write down** the inventory on the inventory card to **equal** the NRV figure.

EXAMPLE

Item	QTY	**Cost Price**	Value of inventory	**Estimated Selling Price**	Less Disposal Expenses	**NRV**	**Lower of Cost & NRV**	Value of Inventory
Plasma Television	5	**3000**	15,000	**2500**	125	**2375**	**2375**	11,875
OLED Television	20	**5000**	100,000	**8000**	400	**7600**	**5000**	100,000

Inventory Write Down is required to record the anticipated loss and to **adjust** the Inventory valuation:

Inventory write down is $3000 - $2375 = $625 per 5 Televisions = $3125

Or Value of Inventory at cost = $15,000 compared to NRV of $11,875

General Journal

Date	Details	Debit	Credit
Jan 31	Inventory write-down	*3125*	
	Inventory		*3125*

What is the effect on Assets Liabilities and Owner's Equity if Inventory Write-down is not completed?

	Overstated Understated No Change	**Amount**
Assets	Overstated	***3125***
Liabilities	No effect	
Owner's Equity	**Overstated**	***3125***

Inventory Item: Sony Wega

Date	**Details**	**IN**			**OUT**			**BALANCE**		
2019		**Qty**	**Unit Cost $**	**Total Cost $**	**Qty**	**Unit Cost $**	**Total Cost $**	**Qty**	**Unit Cost $**	**Total Cost $**
Jan 31	Balance							5	3000	15000
	Memo no. *Write-down*				5	625	3125	5	2375	11875

The write-down is recorded in the OUT column; however, the inventory is **not** leaving the business. The inventory is reduced in VALUE not Quantity. Treat the out column as an ADJUSTMENT column when writing down inventory.

The amount shown in the Out column is the Cost price **less** the NRV price.

Income Statement (Pro Forma)

Revenue		
Sales	100,000	
Less: Sales Returns	2,000	98,000
Less: Cost of Goods Sold		
Cost of Sales (product costs)	40,000	
Buying expenses (period cost)	1,000	
Freight (period cost)	2,000	43,000
Gross Profit		55,000
Less: Inventory Loss	1,000	
Less: Inventory write-down	4,000	5,000
Adjusted Gross Profit		50,000

Cannot be logically allocated to inventory items

Not part of COGS because they are not related to getting inventory into position or condition

Regularly practise this layout of the Income Statement.
Remember to include all sub headings.

Extract from 2009 VCAA exam

Sporting Life carries a line of imported netballs supplied by Pro Netball Suppliers (India).

At 31 December 2019, inventory records revealed the following:

Pay close attention to column headings
Do you add or subtract Import Duties?

Type	Quantity	Purchase Price per Unit	Import Duties per Unit	Unit Selling Price
Pro-Junior	100	$15	$3	$30
Pro-Senior	120	$25	$4	$40
Pro-Leather Exclusive	80	$58	$7	$80

Additional information:

- Each ball sold comes with a signed poster of the Australian netball team. This costs the business $5 per poster. At 31 December 2019 there were 90 posters on hand. Posters are purchased as required.
- The Pro-Leather Exclusive balls have not sold well so the selling price will be reduced to $60 each to clear inventory.
- Inventory is valued at the lower of cost and net realisable value.

QUESTION 49

a. **Calculate** the cost price of each type of netball.

Pro Junior	
Pro Senior	
Pro Leather	

b. **Calculate the NRV of the Pro-leather netballs:**

Calculation

c. **Prepare** the journal entry to write-down any inventory at the 31st December 2019.

General Journal

Date	Details	Debit	Credit

d. **Explain** how the Qualitative characteristics of Faithful Representation and Relevance supports this action to write-down inventory.

QUESTION 50
EFC has one model of football boots called Ultra-Fast that retails for $200.
At the beginning of December 2019 they introduce a new brand of football boots called Lightning Flash. EFC believes they will now only be able to sell the Ultra-Fast boots for $100 each, after an advertising campaign costing a total of $500. They record this information on Memo 1. The Inventory Card for Ultra-Fast on balance date shows:

Inventory Item: Ultra-Fast Football Boots
FIFO

Date 2019	Details	Qty	IN Cost	Total $	Qty	OUT Cost	Total $	Qty	BAL Cost	Total $
30-Nov	***Balance***							20 30	120 140	2400 4200

(a) **Calculate** the adjustment to the inventory of Ultra-Fast football boots.

Write-Down $	

(b) **Complete** the General Journal to record the inventory write-down. Narration is required.

General Journal

Date	Details	Debit	Credit

(c) **Update** the inventory card for Ultra-Fast Football Boots.

(d) **State and explain** a Qualitative Characteristic that justifies this adjustment.

Characteristic:

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Explanation:

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(e) **Identify** the effect on the Balance Sheet after the above adjustment has been made.

	Increase/Decrease/No Effect	Amount $
Assets		
Liabilities		
Owner's Equity		

(f) **Explain** why an inventory-write down is treated as an expense.

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QUESTION 51

Gerard Gardening sells gardening equipment and gardening related products. The following source document was found in the offices of Gerard Gardening and is yet to be recorded:

COSTELLO LITTLE			
Date: 07/08/19		**Tax Invoice:** 22	
Charge to: Gerard Gardening			
Item	**Qty**	**Unit Cost**	**$**
Tien Tap	30	35	1 050
Braganza Bend	25	50	1 250
Sam Snake	15	80	1 200
			3 500
Packaging	70	5	350
			3 850
Delivery Charge			40
			3 890
		GST	389
		Total	4 279
Terms 2/7, n/30			

Required:

(a) Using product costing, **calculate** the cost price of each 'Tien Tap as it would be recorded in the Inventory Card.

Calculation	
Cost price of one 'Tien Tap'	$

(b) 7 Sam Snakes were sold during August. Explain the effect on the accounting reports if the packaging costs were treated as a period cost instead of a product cost.

Identify whether Net Profit will be higher or lower.

	$ Amount
Higher	
Lower	

Explain your answer.

Identify the effect on the Balance Sheet.

	Increase/decrease/ no effect	$ Amount
Assets		
Liabilities		
Owner's Equity		

Explain your answer.

(c) Using product costing, **record** the details from Invoice 22 into the General Journal and the Inventory Card for the 'Braganza Bend'.

General Journal

Date	Details	Debit	Credit

Product: 'Braganza Bend'

Date	Details	In			Out			Balance		
2019		Qty	Cost	Total	Qty	Cost	Total	Qty	Cost	Total
06/08	Balance							7	50	350

QUESTION 52: VCAA Exam 2008

Gary's Guitars

Gary Wood operates a small business, Gary's Guitars, selling acoustic and electric guitars. Gary's accountant maintains a double entry accrual accounting system. The business uses a perpetual inventory recording system with the FIFO (First In, First Out) cost assignment method.

The business prepares financial reports on an annual basis at 31 December each year.

At 31 December 2019 an examination of inventory records (see table below) indicated an inventory loss and the need to write down the value of one item.

Model	Quantity on Inventory Card	Quantity from physical Inventory count	Unit Cost Price	Normal Unit Selling Price	Net Realisable Value
Gibner Electric	20	20	$250	$550	$550
Gibner Acoustic	15	14	$120	$250	$250
Gibner Bass	12	12	$220	$450	$200
Gibner Electric Deluxe	15	14	$350	$750	$750

Required:

a. Using the information contained in the above table, **calculate**

i. Value of the inventory loss.

Inventory Loss $

ii. Value of the inventory write-down.

Inventory Write-down $

iii. Total value of Inventory on hand at 31 December 2019.

Total inventory value $

b. **Explain** what is meant by the term Net Realisable Value.

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c. **Prepare** the General Journal entry required to record the inventory write-down. (Narration is **not** required.)

General Journal

Date	Details	Debit	Credit

On 3 January 2019 the following invoice was received with a delivery of inventory that included a new model of guitar – Gibner Acoustic Deluxe.

GIBNER LTD

ABN: 854 874 610
1340 Nepean Highway,
Seaview
Ph: (03) 9100 9999

Tax Invoice No.: GL23

Date: 3/01/2019

To: Gary's Guitars

Item	Quantity	Unit Cost $	Value $
Gibner Electric	12	250	3 000
Gibner Acoustic	15	120	1 800
Gibner Acoustic Deluxe	20	150	3 000
			7 800
Freight charge	47	30	1 410
			9 210
+ Insurance on delivery	1	180	180
Subtotal			9 390
+ GST (10%)			939
Total due			10 329
Terms: 2/10, n/30			

In previous reporting periods the business has recorded all additional costs associated with purchasing inventory as period costs. The accountant now suggests the business should use product costing where appropriate.

He states that this may result in a small change in profit in the current reporting period.

Required:

QUESTION 53

a. Using product costing, **record** the appropriate information from the invoice above into the General Journal and Inventory card.

General Journal

Date	Details	Debit	Credit

The Inventory Card for Gibner **Acoustic Deluxe** guitars.

Date	Details	IN			OUT			BALANCE		
2019		Qty	Unit Cost $	Total Cost $	Qty	Unit Cost $	Total Cost $	Qty	Unit Cost $	Total Cost $

b. **Explain** how using product costing rather than period costing may result in a change in profit in the current reporting period.

Cost of Sales is (CP x Q)

The quantity is the same as the quantity sold. Therefore, increasing sales volume will improve this ratio.

$$\frac{\text{Average Inventory}}{\text{Cost of Goods Sold}} \times 365 = \text{days}$$

Inventory turnover – ***measures the average number of days that it takes to sell Inventory from the date that it is purchased. The lower the number of days the better the ratio.***

INTERPRET COST OF SALES

Ratio will increase (worsen) if cost of sales decreases relative to average Inventory.

Reasons:

- Decrease in advertising.
- Increase in selling prices.
- New competitors.
- Poor quality products
- Poor customer service

RATIO will decrease (improve) if cost of sales increases relative to average Inventory.

Reasons:

- Increase in advertising.
- Decrease in selling prices.
- Loss of competitors.
- New marketing strategies.
- Improved quality products
- Better customer service

$$\frac{\textbf{Average Inventory x 365}}{\textbf{Cost of Goods Sold}}$$

INTERPRET AVERAGE INVENTORY LEVELS

Ratio will increase (worsen) if Inventory levels increase relative to cost of sales

Reasons:

- Bulk purchase of Inventory.
- Increasing Inventory levels in anticipation of future sales.
- Inventory gains.