

# INVENTORY HELD FOR RESALE

## GENERAL INFORMATION

The preparation of financial statements requires carefully determining an appropriate dollar amount of inventory. Usually, that amount is presented as a current asset in the balance sheet and is a direct determinant of expenditures; as such, it has a significant impact on the net change in fund balance. In applying the matching principle when determining net income, the valuation of inventories is of primary importance.

## BACKGROUND

Inventories of goods held for resale must periodically be compiled, measured, and recorded in the university's financial accounting system. Sample inventory guidelines are available from Financial Services. Inventory is usually classified as (a) finished goods (e.g., *consumable supplies and items held for resale or recharge within the university*), (b) work in process, or (c) raw materials.

The basis of accounting for inventories is cost, which is the price paid or consideration given to acquire the asset. In inventory accounting, cost is the sum of the expenditures and charges, direct and indirect, in bringing goods to their existing condition or location.

## INVENTORY SYSTEMS

### Periodic System

Inventory is determined by a physical count (*note that sample inventory guidelines are available from Financial Services*) **as of a specific date**. As long as the count is made frequently enough for reporting purposes, it is not necessary to maintain extensive inventory records. The inventory shown in the balance sheet is determined by the physical count and is priced in accordance with the inventory method used.

### Perpetual System

With the perpetual system, inventory records are **maintained and updated continuously** as items are purchased and sold. The system has the advantage of providing inventory information on a timely basis but requires the maintenance of a full set of inventory records. Periodic physical counts are still necessary to verify the inventory records.

## LOWER OF COST OR MARKET

When the value of the goods in the ordinary course of business is no longer as great as their cost, a departure from the cost principle of measuring the inventory is required. Whether the cause is obsolescence, physical deterioration, changes in price levels, or any other, the difference should be recognized by a charge to expense in the current period. This is usually accomplished by stating the goods at a lower level designated as market. The term market generally means current replacement cost, whether by purchase or by reproduction.

## INVENTORY COSTING METHODS

For inventory purposes, cost may be determined by specific identification or by the association of the flow of cost factors— **first-in, first-out (FIFO)**, **last-in, first-out (LIFO)**, and **average cost**.

The **FIFO method** of identifying inventory is based on the assumption that costs are charged against revenue in the order in which they occur. The inventory remaining on hand is presumed to consist of the most recent costs.

The **LIFO method** matches the most recent costs incurred with current revenue, leaving the first costs incurred to be included as inventory.

The **average cost method** of inventory valuation assumes that costs are charged against revenue based on an average of the number of units acquired at each price level. The resulting average price is applied to the ending inventory to find the total ending inventory value.

Because of the great variety and quantity of inventory in some types of businesses, the *reversed markup procedure* of inventory pricing, such as the *retail inventory method*, may be both practical and appropriate. The **retail inventory method** requires the maintenance of records of purchases at both cost and selling price. A ratio is calculated and applied to the ending inventory at retail to compute approximate value.

## **DEPARTMENTAL RESPONSIBILITY**

Selecting, establishing, and maintaining an inventory system (*i.e., a periodic or perpetual system*).

Determining whether obsolescence, physical deterioration, change in price levels, or any other changes require inventory to be restated to the lower of cost or market.

Selecting an inventory cost method that under the circumstances most clearly reflects periodic income.

Ensure that inventory transactions are executed and recorded in accordance with management's general or specific authorization.

Access to inventories is to be permitted only in accordance with management's authorization. Management may protect its resources by establishing physical barriers and appropriate policies. For example, inventories may be kept in a storeroom.

Adopt internal control structure policies and procedures that periodically compare the actual asset with its recorded balance. An important part of the internal control structure is to determine the effectiveness of recording policies and asset access policies. This is accomplished by conducting periodic physical counts of inventory and comparing the counts to the balance in the general ledger.

Should you have any questions or need additional information related to inventories, contact Financial Services, Evans Hall, Room 303, at 325-3021.