ANSWERS TO QUESTIONS

1. Agree. Effective inventory management is frequently the key to successful business operations. Management attempts to maintain sufficient quantities and types of goods to meet expected customer demand. It also seeks to avoid the cost of carrying inventories that are clearly in excess of anticipated sales.

2. Inventory items have two common characteristics: (1) they are owned by the company and (2) they are in a form ready for sale in the ordinary course of business.

3. Taking a physical inventory involves actually counting, weighing or measuring each kind of inventory on hand. Retailers, such as a hardware store, generally have thousands of different items to count. This is normally done when the store is closed.

4. (a) (1) The goods will be included in Reeves Company's inventory if the terms of sale are FOB destination.
(2) They will be included in Cox Company's inventory if the terms of sale are FOB shipping point.
(b) Reeves Company should include goods shipped to another company on consignment in its inventory. Goods held by Reeves Company on consignment should not be included in inventory.

5. Inventoriable costs are $3,020 (invoice cost $3,000 + freight charges $50 – purchase discounts $30). The amount paid to negotiate the purchase is a buying cost that normally is not included in the cost of inventory because of the difficulty of allocating these costs. Buying costs are expensed in the year incurred.

6. FOB shipping point means that ownership of goods in transit passes to the buyer when the public carrier accepts the goods from the seller. FOB destination means that ownership of goods in transit remains with the seller until the goods reach the buyer.

7. Actual physical flow may be impractical because many items are indistinguishable from one another. Actual physical flow may be inappropriate because management may be able to manipulate net income through specific identification of items sold.

8. The major advantage of the specific identification method is that it tracks the actual physical flow of the goods available for sale. The major disadvantage is that management could manipulate net income.

9. No. Selection of an inventory costing method is a management decision. However, once a method has been chosen, it should be used consistently from one accounting period to another.

10. (a) FIFO.
(b) Average-cost.
(c) LIFO.

11. Plato Company is using the FIFO method of inventory costing, and Cecil Company is using the LIFO method. Under FIFO, the latest goods purchased remain in inventory. Thus, the inventory on the balance sheet should be close to current costs. The reverse is true of the LIFO method. Plato Company will have the higher gross profit because cost of goods sold will include a higher proportion of goods purchased at earlier (lower) costs.

12. Casey Company may experience severe cash shortages if this policy continues. All of its net income is being paid out as dividends, yet some of the earnings must be reinvested in inventory to maintain inventory levels. Some earnings must be reinvested because net income is computed with cost of goods sold based on older, lower costs while the inventory must be replaced at current, higher costs. Because of this factor, net income under FIFO is sometimes referred to as "phantom profits."

13. Peter should know the following:
(a) A departure from the cost basis of accounting for inventories is justified when the value of the goods is lower than its cost. The writedown to market should be recognized in the period in which the price decline occurs.
(b) Market means current replacement cost, not selling price. For a merchandising company, market is the cost at the present time from the usual suppliers in the usual quantities.

14. Garitson Music Center should report the CD players at $380 each for a total of $1,900. $380 is the current replacement cost under the lower-of-cost-or-market basis of accounting for inventories. A decline in replacement cost usually leads to a decline in the selling price of the item. Valuation at LCM is conservative.

15. Ruthie Stores should report the toasters at $27 each for a total of $540. The $27 is the lower of cost or market. It is used because it is the lower of the inventory's cost and current replacement cost.

16. (a) Mintz Company's 2011 net income will be understated $7,000; (b) 2012 net income will be overstated $7,000; and (c) the combined net income for the two years will be correct.

17. Willingham Company should disclose: (1) the major inventory classifications, (2) the basis of accounting (cost or lower of cost or market), and (3) the costing method (FIFO, LIFO, or average).

18. An inventory turnover that is too high may indicate that the company is losing sales opportunities because of inventory shortages. Inventory outages may also cause customer ill will and result in lost future sales.

19. PepsiCo uses the average, first-in, first-out or last-in, first-out methods for its inventories.

***20.** Disagree. The results under the FIFO method are the same but the results under the LIFO method are different. The reason is that the pool of inventoriable costs (cost of goods available for sale) is not the same. Under a periodic system, the pool of costs is the goods available for sale for the entire period, whereas under a perpetual system, the pool is the goods available for sale up to the date of sale.

***21.** In a periodic system, the average is a weighted average based on total goods available for sale for the period. In a perpetual system, the average is a moving average of goods available for sale after each purchase.

***22.** Inventories must be estimated when: (1) management wants monthly or quarterly financial statements but a physical inventory is only taken annually and (2) a fire or other type of casualty makes it impossible to take a physical inventory.

***23.** In the gross profit method, the average is the gross profit rate, which is gross profit divided by net sales. The rate is often based on last year's actual rate. The gross profit rate is applied to net sales in using the gross profit method.

In the retail inventory method, the average is the cost-to-retail ratio, which is the goods available for sale at cost divided by the goods available for sale at retail. The ratio is based on current year data and is applied to the ending inventory at retail.

***24.** The estimated cost of the ending inventory is $40,000:

Net sales	$400,000
Less: Gross profit ($400,000 X 35%)	140,000
Estimated cost of goods sold	$260,000
Cost of goods available for sale	$300,000
Less: Cost of goods sold	260,000
Estimated cost of ending inventory	$ 40,000

***25.** The estimated cost of the ending inventory is $28,000:

Ending inventory at retail: $40,000 = ($120,000 – $80,000)

Cost-to-retail ratio: $70\% = \left(\dfrac{\$84{,}000}{\$120{,}000}\right)$

Ending inventory at cost: $28,000 = ($40,000 X 70%)