

II. INVENTORY ERRORS

Suppose ending inventory was miscounted and therefore mispriced. Profits for the year in question and the next year will be affected. For example, if the 1996 ending inventory, correctly valued at \$10,000, was erroneously recorded at \$8,000, the effect would be as follows:

	1996	1997	1998
Sales	\$60,000	\$60,000	\$60,000
Cost of Goods Sold:			
Beginning Inventory	10,000	8,000	10,000
Net Purchases	<u>40,000</u>	<u>40,000</u>	<u>40,000</u>
Cost of Goods Available	\$50,000	\$48,000	\$50,000
Ending Inventory	<u>8,000</u>	<u>10,000</u>	<u>10,000</u>
Cost of Goods Sold	<u>\$42,000</u>	<u>\$38,000</u>	<u>\$40,000</u>
Gross Profit	<u>\$18,000</u>	<u>\$22,000</u>	<u>\$20,000</u>

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Note: Because ending inventory was understated in 1996, Cost of Goods Sold was overstated and Gross Profit was understated. The opposite occurs in 1997, as an understated beginning inventory understates Goods Available and Cost of Goods Sold, overstating Gross Profit. By 1998, statements would be correct.

III. LOWER OF COST OR MARKET

Generally accepted accounting principle requires that inventory be reported at the lower of cost or market because a drop in inventory values will likely mean a drop in sales price and profits. Conservatism rules. In addition:

- * Market is generally considered to be replacement cost
- * Inventory Value must be \leq Net Realizable Value (Selling Price - Cost to Sell)
- * Inventory Value must be \geq Net Realizable Value - Normal Profit Margin

LOWER OF COST OR MARKET EXAMPLE						
Product	Units on Hand	Per Unit Value		Total Cost	Total Market	Lower of Cost or Market (by product)
		Cost	Market			
1	10	\$3	\$4	\$30	\$40	\$30
2	15	4	3	60	45	45
3	20	3	2	60	40	40
				<u>\$150</u>	<u>125</u>	<u>\$115</u>
Lower of Cost or Market (by total market)					<u>\$125</u>	

IV. ESTIMATING INVENTORY VALUES

Time constraints or unusual circumstances at times make a physical count of inventory difficult or even impossible. Two methods which value inventory without a count are:

RETAIL METHOD	GROSS PROFIT METHOD																																																												
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