Inventories: Additional Valuation Issues

Chapter 9

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Lower of Cost or Market (LCM)

The general rule is that -

The historical cost principle is abandoned when the future utility (revenue-producing ability) of the asset is no longer as great as its original cost.

The meaning of “Market”

\[ \text{Cost} - \frac{\text{Market}}{} = \text{LCM} \]
“Market” (Illust. 9-2 pg. 450)

![Diagram](link)

What is the rationale for these two limitations?

ABC Company
Income Statement

<table>
<thead>
<tr>
<th>Allowance</th>
<th>Direct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$200,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>120,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>80,000</td>
</tr>
</tbody>
</table>

Operating expenses:
- Selling | 45,000 | 45,000 |
- General and administrative | 20,000 | 20,000 |

Total operating expenses | 65,000 | 65,000 |

Other revenue and expense:
- Loss on inventory | 12,000 | - |
- Interest income | 5,000 | 5,000 |

Total other | (7,000) | 5,000 |

Income from operations | 8,000 | 8,000 |

Income tax expense | 2,400 | 2,400 |

Net income | $5,600 | $5,600 |

ABC Company
Balance Sheet

<table>
<thead>
<tr>
<th>Allowance</th>
<th>Direct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>350,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>770,000</td>
</tr>
<tr>
<td>Less: inventory allowance</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Prepaids</td>
<td>20,000</td>
</tr>
</tbody>
</table>

Total current assets | 1,228,000 | 1,228,000 |
**Retail Inventory Method**

- Like Gross Profit Method, the Retail Method provides an estimate of ending inventory.
- Unlike the GP Method, it produces estimates that may be acceptable for financial statement (reporting) purposes.

**Variation of Retail Method**

Can be adapted for use with:
- any cost flow assumption (FIFO, LIFO, or Average)
- either inventory valuation method (cost or LCM)
- either of the LIFO approaches (unit LIFO or Dollar Value LIFO)

**Variation of Retail Method**

Textbook Illustrates:
- LCM Method (conventional retail)
- Cost Method (average cost)

Appendix 9A:
- LIFO at cost with stable prices (LIFO retail)
- LIFO at cost with fluctuating prices (dollar-value LIFO retail)
**Appraisal of Retail Method**

Method permits:
- the computation of net income without a physical count of inventory
- a control measure in determining inventory shortages.
- regulation of quantities of merchandise on hand.
- information needed for insurance purposes.

**Disclosure of Inventory**

- Composition of manufactured inventory .......
  (raw materials, WIP, and finished goods)
- Unusual or significant financing arrangement
  (related party transactions, firm purchase commitments, etc.)
- Inventory costing methods used.
- Consistency of costing methods from one period to another.