Inventory

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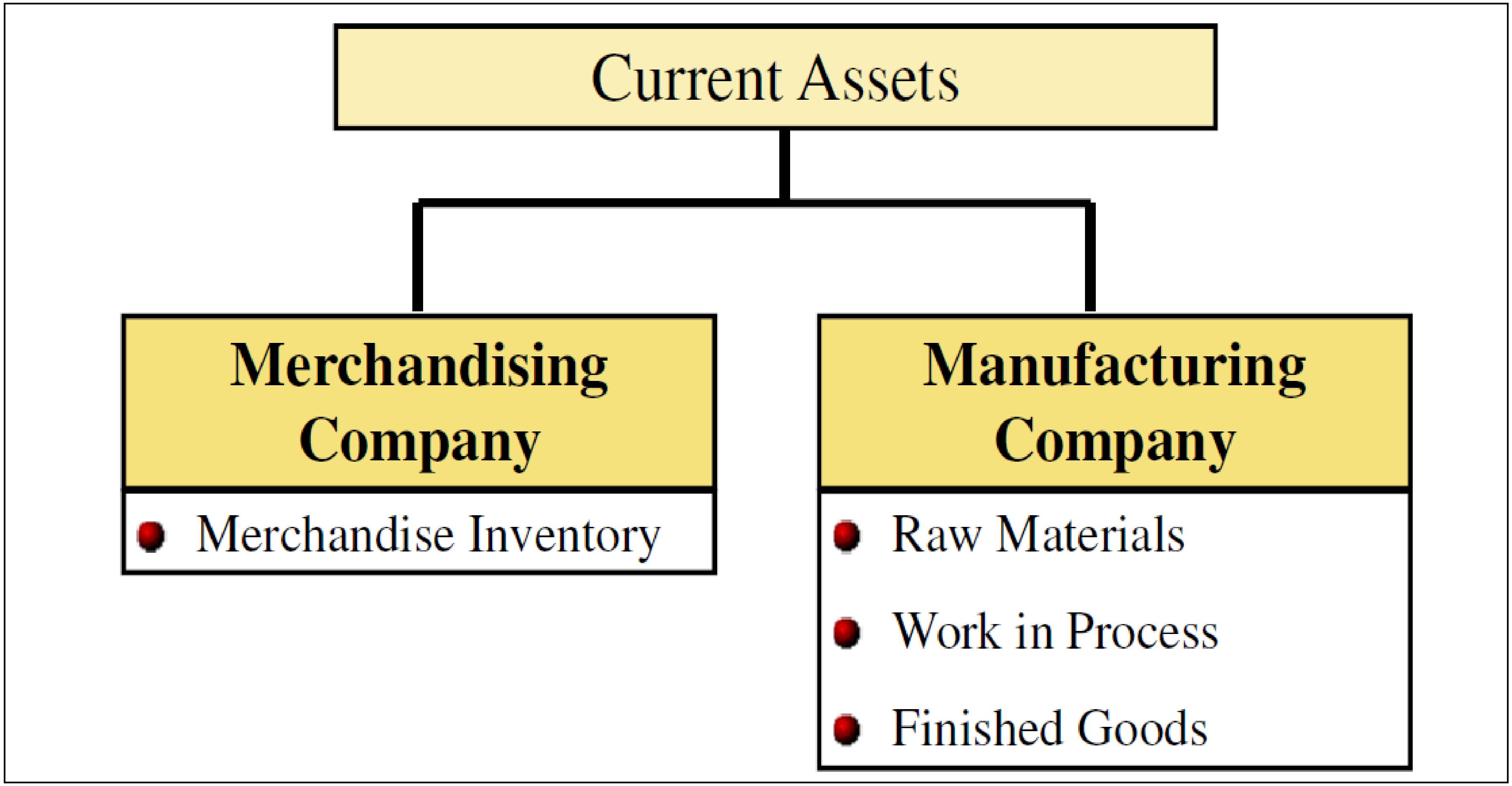
Inventory

- Classification of inventory
- Why valuation of inventory is important?
- Effects of misstatement in Inventory
- Cost of goods sold
- Closing entries
- Ending inventory: lower of cost and net realizable value
- Sale or return
- Right of return
- Abnormal loss

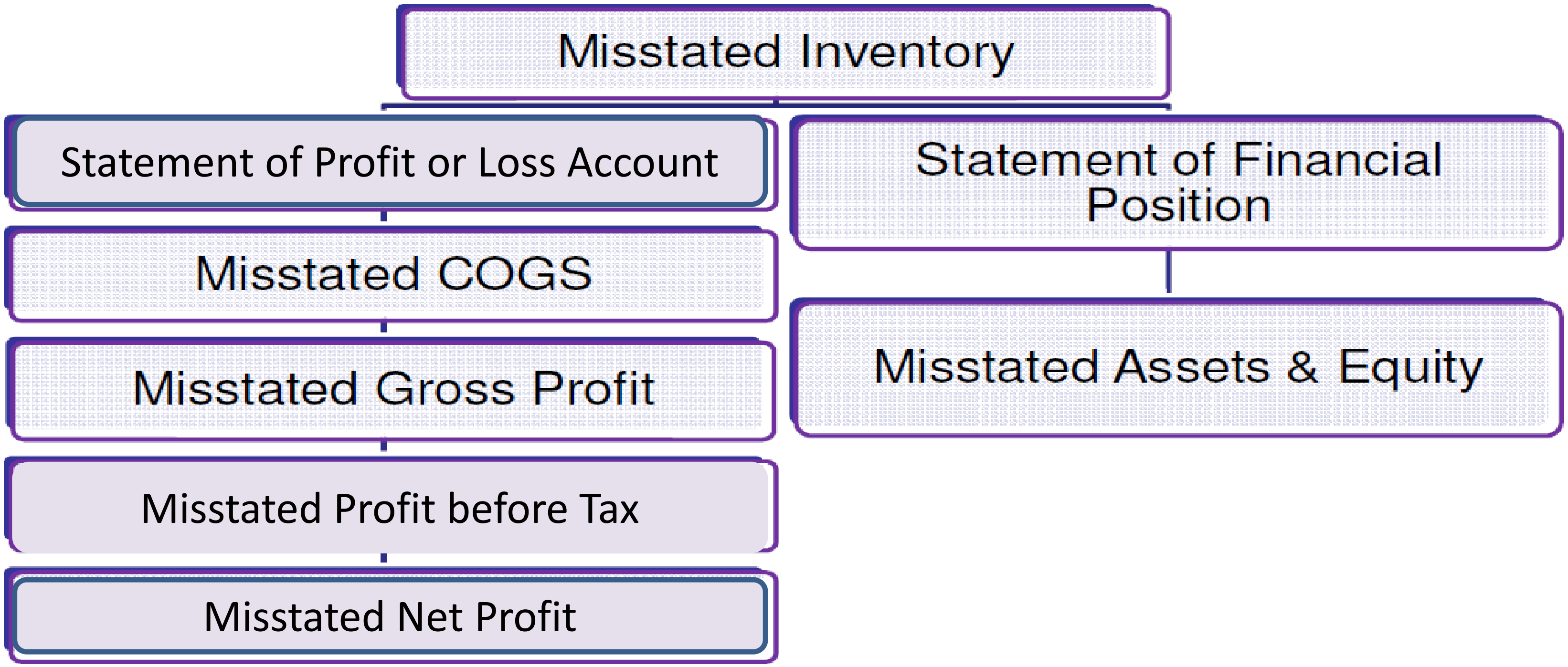
Classification of inventory



Why valuation of inventory is important?

- The valuation of inventory is important in retail / manufacturing business because the inventory is normally a significant item under the current asset in the statement of financial position.
- The overstatement or understatement of inventory will affect the amount of cost of goods sold and gross profit, which in turn will affect the ratios for decision-making of the users of financial statements.

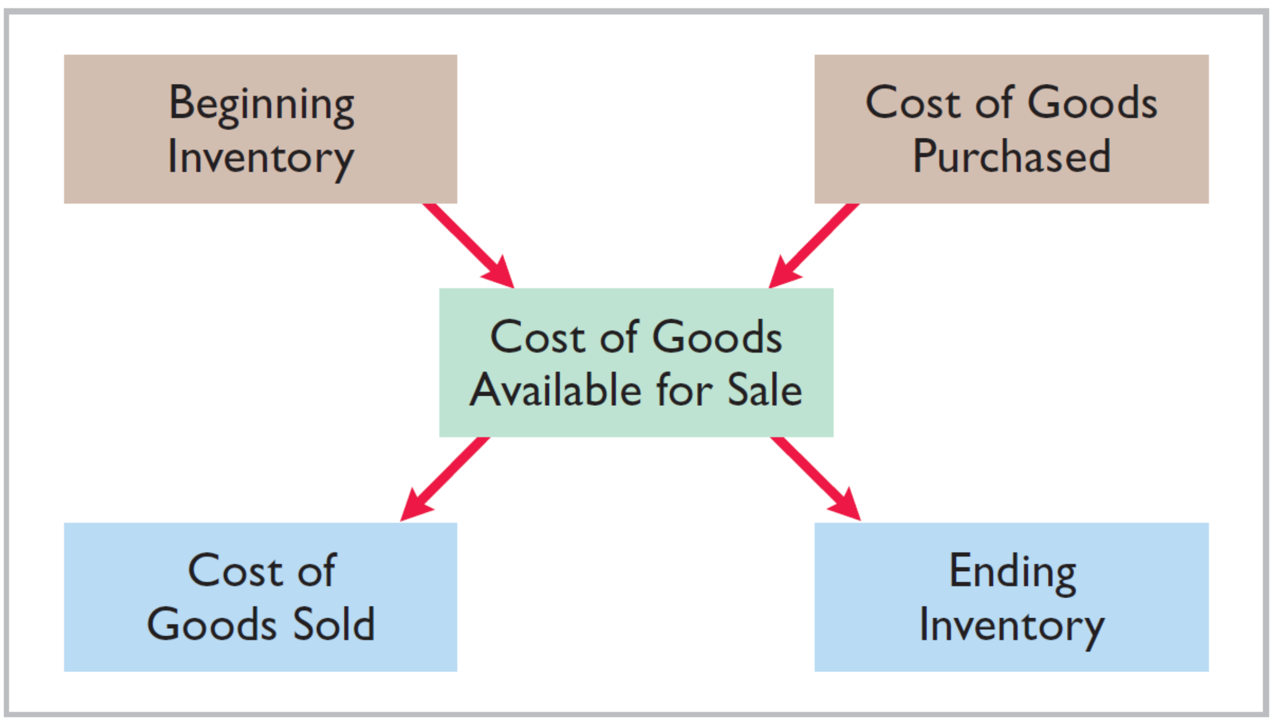
Effects of misstatement in inventory



The ending inventory of one year becomes the beginning inventory (and affects the net profit) of the next year

Cost of Goods Sold

Beginning Inventory
+ Cost of Goods Purchased
Cost of Goods Available for Sale
-Ending Inventory
Cost of Goods Sold



Cost of Goods Sold

Beginning Inventory
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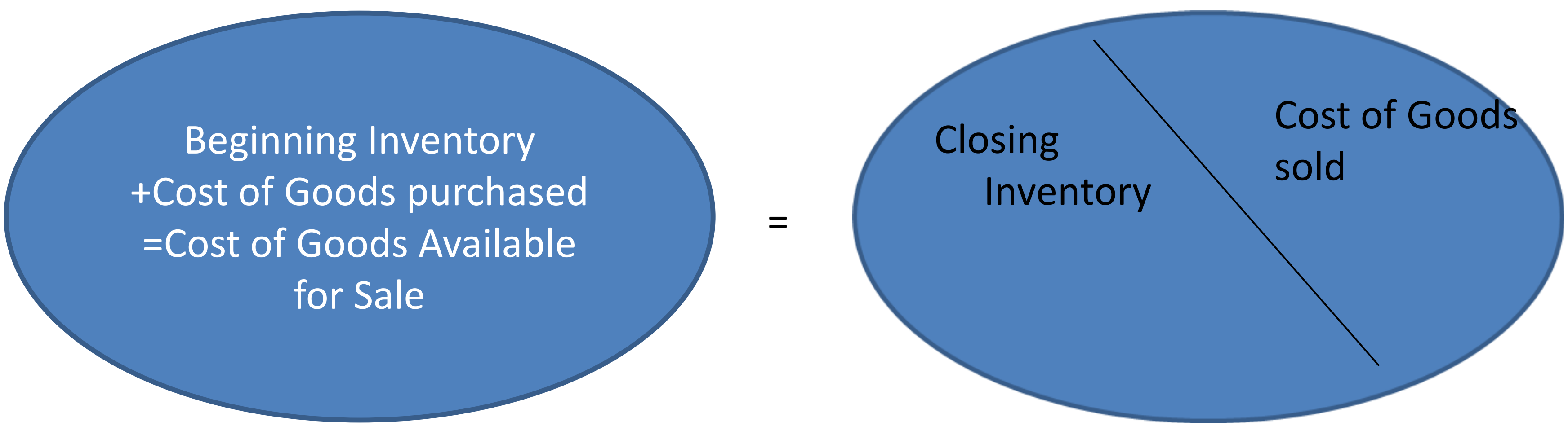
Cost of Goods Sold



Closing entries

Dr Inventory (ending balance)

Dr Profit or loss account

Dr Purchase returns

    Cr Inventory (beginning balance)

    Cr Purchases

    Cr Carriage inwards

Cost of Goods Available for Sale

Ending inventory: Lower of cost and net realizable value

- Inventories shall be measured at the lower of cost and net realizable value.
- The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.
- Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale (examples: the costs of finishing, repair, advertising expenses directly related to inventory and transportation costs borne by the owner) .

Lower of Cost and Net Realizable Value

China Mobile : 2018 annual report

(k) **Inventories**

Inventories are carried at the lower of cost and net realizable value. Cost represents purchase cost of goods calculated using the weighted average cost method. Net realizable value is determined by reference to the sales proceeds of items sold in the ordinary course of business or to management's estimates based on prevailing market conditions.

When inventories are sold, the carrying amount of those inventories is recognized as cost of products sold. The amount of any write-down of inventories to net realizable value and all losses of inventories are recognized as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realizable value, is recognized as a reduction in the amount of inventories recognized as an expense in the period in which the reversal occurs. No reversal of any write-down of inventories occurred during the years presented.

https://www.chinamobileltd.com/en/ir/reports/ar2018.pdf

Lower of Cost and Net Realizable Value

Tsui Wah Holdings annual report :2018

Inventories

Inventories are stated at the lower of cost and net realisable value. Cost is determined on the first-in, first-out basis. Net realisable value is based on estimated selling prices less any estimated costs to be incurred to completion and disposal.

http://www.tsuiwah.com/wp-content/uploads/2018/07/EW01314.pdf

Lower of Cost and Net Realizable Value

Luk Fook Holdings (International) Limited : Annual report 2018

3.10 Inventories

Inventories, comprise raw materials and finished goods, are stated at the lower of cost and net realisable value. Cost is determined on the first-in, first-out basis. The cost of finished goods comprises raw materials, direct labour and other direct costs. It excludes borrowing costs. Net realisable value is the estimated selling price in the ordinary course of business, less applicable variable selling expenses.

3.10 存貨

存貨（包括原材料及製成品）乃按成本值與可變現淨值兩者之較低者列賬。成本採用先入先出法釐定。製成品成本包括原材料、直接勞工成本及其他直接成本，惟不包括貸款成本。可變現淨值乃按於日常業務過程中之估計售價減適用之可變銷售費用。

Net Realizable Value

- Timing of review
  - Each financial year
- Situations of NRV < cost
  - Fall in selling price (impact on Huawei for the trade war)
  - Physical deterioration of inventories (goods not keep in good condition)
  - Obsolescence of products (mobile phones and accessories, electrical appliances)

Lower of cost and net realizable value Adjusting entries :

Dr Profit or loss account

Cr Inventory

Assumption: the business have not applied the lower of cost and NRV in its inventory valuation in case the NRV is found less than its cost

Sale or Return

- Sale or Return is an arrangement by which a customer/retailer pays only for goods sold(accepted), returning those that are unsold to the supplier.
- Example : Newspaper , text books if publisher allow stores to return.

Sale or Return - example

- **Sale or Return basis, is an arrangement in which a supplier provides goods to a customer (retailer) who pays for the goods only when they are resold (accepted).** The goods remain property of the supplier. If the goods are not sold after a certain time period, the customer reserves the right to return the goods to the supplier.
- Sale or Return arrangements require no commitment on the part of the customer and thus are perfect for situations when goods have not yet proven their market value or durability. This can provide incentive for customers to stock goods they may find too risky to keep in their inventory. Magazines, newspapers and seasonal goods such as garden seeds and Christmas decorations are often sold on Sale or Return. This allows customers (retailers) to offer a wider range of this material without the risk of being stuck with goods that are out of date or only sell during specific times of the year. Certain industries such as publishers and book distributors have long functioned on Sale or Return agreements.

Sale or Return - questions from student on web

- **Sales or return basis!! 求救**
- 其實之前聽左好多次都唔係好明，以下係一啲問題，麻煩大家幫忙解答

  1. 當我俾貨人，on sale or return basis, 我需要入咩entry呢？佢未賣，我又可唔可以當sales呢？

  2. 佢賣唔出貨，退番俾我，我又應該入咩entry呢？

  3. Suppose有人俾貨我，on sale or return basis, 我應該入咩entry呢？

  4. 如果我賣唔出啲貨，退番俾人，我又要入咩entry呢？

  5. 以上既變動係唔係關inventory事架？

  我concept真係唔多清-v-" 麻煩大家解答，thank you!

www.discuss.com.hk/viewthread.php?tid=22912362

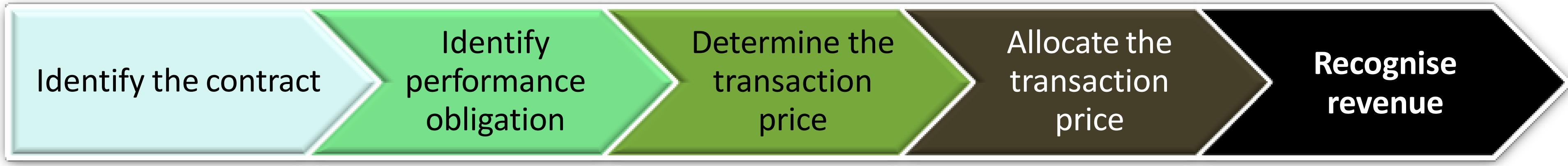
Step 5: Recognise Revenue

- At contract inception, an entity first evaluates whether it ***transfers control*** of the good or service ***over time*** if not, then it transfers control ***at a point in time***.

- ***Control*** refers to the customer's ability to
  - direct the use of, and obtain substantially all of the remaining benefits from, an asset; or
  - prevent other entities from directing the use of, and obtaining the benefits from, an asset.

- HKFRS 15 includes indicators as to when transfer of control occurs. Indicators that control has passed included a customer having:-
  - a present obligation to pay
  - physical possession
  - legal title
  - risks and rewards of ownership
  - accepted the asset

Step 5



Right of return

- Under HKFRS 15, when an entity makes a sale with a right of return it recognises revenue. The entity also recognises a refund liability and an asset for any goods or services that it expects to be returned.

- An entity applies the accounting guidance when a customer has a right to:
  - a full or partial refund of any consideration paid;
  - a ***credit*** that can be applied against amounts owed, or that will be owed, to the entity; or
  - another product in exchange (unless it is another product of the same type, quality, condition, and price – i.e. an exchange)
- When an entity makes a sale with a right of return, it initially recognises the following:-
  - ***Revenue***: at the gross transaction price ***less*** the expected level of returns
  - ***Refund liability***: at the expected level of returns
  - ***Estimated inventory return***: by reference to the carrying amount of the products expected to be returned, less the expected recovery costs
  - ***Cost of goods sold***: as the carrying amount of good sold less the estimated inventory return
  - ***Reduction of inventory*** : as the carrying amount of goods transferred to the customer

Right of Return

- Facts: Venden Company sells 100 products for $100 each to Amaya Inc. for cash. Venden allows Amaya to return any unused product within 30 days and receive a full refund. The cost of each product is $60. To determine the transaction price, Venden decides that the approach that is most predictive of the amount of consideration to which it will be entitled is the most likely amount. Using the most likely amount, Venden estimates that:
- Three products will be returned.
- The costs of recovering the products will be immaterial.
- The returned products are expected to be resold at a profit.

Required: Prepare journal entries to reflect the sale?

Example

Dr Bank	10,000	
Cr Refund liability ($100 x 3)		300
Cr Revenue ($100 x 97)		9,700

To recognise the sale excluding revenue on products expected to be returned

Dr Estimated inventory returns ($60 x 3)	180	
Dr Costs of sales ($60 x 97)	5,820	
Cr Inventory ($60 x 100)		6,000

Perpetual System!

To recognise the cost of sales and the right to recover products from customers

The estimated inventory returns is still included as part of the ending inventory

Right of Return

Question: How should Venden record when a return occurs?

When a return of two units occurs, Venden records the following entries.

Refund Liability ($100 x 2)	200	
Cash		200
Returned Inventory ($60 x 2)	120	
Estimated Inventory Returns		120

Companies may record the returned asset in a separate account from inventory to provide transparency.

Abnormal loss of inventory

- ***Abnormal loss of stock can be due to***

  theft, fire or other natural calamity

Presentation of abnormal loss in Statement of Profit or Loss Account

- The abnormal inventory loss will appear as a separate expense item in the Profit or Loss Account
- The normal loss of inventory is absorbed in Cost of Goods Sold.

Q & A?