

Complete P7-3 (pages 369–370) and CP7-2 (page 376) from Chapter 7 of your Financial Accounting textbook

P7-3

Evaluating Four Alternative Inventory Methods Based on Income and Cash Flow (AP7-2) LO7-2, 7-3

At the end of January 2014, the records of Donner Company showed the following for a particular item that sold at \$16 per unit:

Transactions	Units	Amount
Inventory, January 1, 2014	500	\$2,365
Purchase, January 12	600	3,600
Purchase, January 26	160	1,280
Sale	(370)	
Sale	(250)	

Required:

1. Assuming the use of a periodic inventory system, prepare a summarized income statement through gross profit for the month of January under each method of inventory: (a) average cost, (b) FIFO, (c) LIFO, and (d) specific identification. For specific identification, assume that the first sale was selected from the beginning inventory and the second sale was selected from the January 12 purchase. Round the average cost per unit to the nearest cent. Show the inventory computations in detail.
2. Of FIFO and LIFO, which method would result in the higher pretax income? Which would result in the higher EPS?
3. Of FIFO and LIFO, which method would result in the lower income tax expense? Explain, assuming a 30 percent average tax rate.
4. Of FIFO and LIFO, which method would produce the more favorable cash flow? Explain.

CP7-2

Finding Financial Information
LO7-2, 7-4, 7-5, 7-7

Refer to the financial statements of Urban Outfitters given in Appendix C at the end of this book.

Required:

1. The company uses lower of cost or market to account for its inventory. At the end of the year, do you expect the company to write its inventory down to replacement cost or net realizable value? Explain your answer.
2. What method does the company use to determine the cost of its inventory?
3. If the company overstated ending inventory by \$10 million for the year ended January 31, 2012, what would be the corrected value for Income before Income Taxes?
4. Compute the inventory turnover ratio for the current year. What does an inventory turnover ratio tell you?

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On the date of the inventory count, the company received notice from a supplier that goods ordered earlier at a cost of \$3,550 had been delivered to the transportation company on December 27, 2014; the terms were FOB shipping point. Because the shipment had not arrived by December 31, 2014, it was excluded from the physical inventory count.

- On December 31, 2014, the company shipped \$700 worth of goods to a customer, FOB destination. The goods are expected to arrive at their destination no earlier than January 8, 2015. Because the goods were not on hand, they were not included in the physical inventory count.
- One of the items sold by the company has such a low volume that management planned to drop it last year. To induce Travis Company to continue carrying the item, the manufacturer-supplier provided the item on a "consignment basis." This means that the manufacturer-supplier retains ownership of the item, and Travis Company (the consignee) has no responsibility to pay for the items until they are sold to a customer. Each month, Travis Company sends a report to the manufacturer on the number sold and remits cash for the cost. At the end of December 2014, Travis Company had six of these items on hand; therefore, they were included in the physical inventory count at \$950 each.

Required:

Assume that Travis's accounting policy requires including in inventory all goods for which it has title. Note that the point where title (ownership) changes hands is determined by the shipping terms in the sales contract. When goods are shipped "FOB shipping point," title changes hands at shipment and the buyer normally pays for shipping. When they are shipped "FOB destination," title changes hands on delivery, and the seller normally pays for shipping. Begin with the \$80,000 inventory amount and compute the correct amount for the ending inventory. Explain the basis for your treatment of each of the preceding items. (**Hint:** Set up three columns: Item, Amount, and Explanation.)

P7-2**Analyzing the Effects of Four Alternative Inventory Methods (AP7-1)****LO7-2**

Kirtland Corporation uses a periodic inventory system. At the end of the annual accounting period, December 31, 2015, the accounting records for the most popular item in inventory showed the following:

Transactions	Units	Unit Cost
Beginning inventory, January 1, 2015	400	\$3.00
Transactions during 2015:		
a. Purchase, January 30	300	3.40
b. Purchase, May 1	460	4.00
c. Sale (\$5 each)	(160)	
d. Sale (\$5 each)	(700)	

Required:

Compute the amount of (a) goods available for sale, (b) ending inventory, and (c) cost of goods sold at December 31, 2015, under each of the following inventory costing methods (show computations and round to the nearest dollar):

1. Average cost (round the average cost per unit to the nearest cent).
2. First-in, first-out.
3. Last-in, first-out.
4. Specific identification, assuming that the first sale was selected two-fifths from the beginning inventory and three-fifths from the purchase of January 30, 2015. Assume that the second sale was selected from the remainder of the beginning inventory, with the balance from the purchase of May 1, 2015.

P7-3**Evaluating Four Alternative Inventory Methods Based on Income and Cash Flow (AP7-2)****LO7-2, 7-3**

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At the end of January 2014, the records of Donner Company showed the following for a particular item that sold at \$16 per unit:

Transactions	Units	Amount
Inventory, January 1, 2014	500	\$2,365
Purchase, January 12	600	3,600
Purchase, January 26	160	1,280
Sale	(370)	
Sale	(250)	

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*Required:***Page 370**

- Assuming the use of a periodic inventory system, prepare a summarized income statement through gross profit for the month of January under each method of inventory: (a) average cost, (b) FIFO, (c) LIFO, and (d) specific identification. For specific identification, assume that the first sale was selected from the beginning inventory and the second sale was selected from the January 12 purchase. Round the average cost per unit to the nearest cent. Show the inventory computations in detail.
- Of FIFO and LIFO, which method would result in the higher pretax income? Which would result in the higher EPS?
- Of FIFO and LIFO, which method would result in the lower income tax expense? Explain, assuming a 30 percent average tax rate.
- Of FIFO and LIFO, which method would produce the more favorable cash flow? Explain.

P7-4**Analyzing and Interpreting Income Manipulation under the LIFO Inventory Method****LO7-2, 7-3**

Pacific Company sells electronic test equipment that it acquires from a foreign source. During the year 2014, the inventory records reflected the following:

	Units	Unit Cost	Total Cost
Beginning inventory	20	\$12,000	\$240,000
Purchases	42	10,000	420,000
Sales (47 units at \$24,500 each)			

Inventory is valued at cost using the LIFO inventory method.

Required:

- Complete the following income statement summary using the LIFO method and the periodic inventory system (show computations):

Sales revenue	\$ _____
Cost of goods sold	_____
Gross profit	_____
Expenses	300,000
Pretax income	\$ _____
Ending inventory	\$ _____

- The management, for various reasons, is considering buying 20 additional units before December 31, 2014, at \$9,000 each. Restate the income statement (and ending inventory), assuming that this purchase is made on December 31, 2014.

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CASES AND PROJECTS

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Annual Report Cases

CP7-1

Finding Financial Information

LO7-1, 7-2, 7-5

AMERICAN EAGLE OUTFITTERS, INC.

Refer to the financial statements of American Eagle Outfitters given in Appendix B at the end of this book.



Required:

1. How much inventory does the company hold at the end of the most recent year?
2. Estimate the amount of merchandise that the company purchased during the current year. (**Hint:** Use the cost of goods sold equation and ignore “certain buying, occupancy, and warehousing expenses.”)
3. What method does the company use to determine the cost of its inventory?
4. Compute the inventory turnover ratio for the current year. What does an inventory turnover ratio tell you?

CP7-2

Finding Financial Information

LO7-2, 7-4, 7-5, 7-7

Refer to the financial statements of Urban Outfitters given in Appendix C at the end of this book.



URBAN OUTFITTERS, INC.



Required:

1. The company uses lower of cost or market to account for its inventory. At the end of the year, do you expect the company to write its inventory down to replacement cost or net realizable value? Explain your answer.
2. What method does the company use to determine the cost of its inventory?

3. If the company overstated ending inventory by \$10 million for the year ended January 31, 2012, what would be the corrected value for Income before Income Taxes?
4. Compute the inventory turnover ratio for the current year. What does an inventory turnover ratio tell you?

CP7-3**Comparing Companies within an Industry****LO7-5**

**AMERICAN EAGLE
OUTFITTERS, INC.**



Refer to the financial statements of American Eagle Outfitters (Appendix B) and Urban Outfitters (Appendix C) and the Industry Ratio Report (Appendix D) at the end of this book.

Required:

1. Compute the inventory turnover ratio for both companies for the current year. What do you infer from the difference?
2. Compare the inventory turnover ratio for both companies to the industry average. Are these two companies doing better or worse than the industry average in turning over their inventory?



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Financial Reporting and Analysis Cases

**CP7-4****Using Financial Reports: Interpreting the Effect of Charging Costs to Inventory as Opposed to Current Operating Expenses****LO7-1**

Dana Holding Corporation designs and manufactures component parts for the vehicular, industrial, and mobile off-highway original equipment markets. In a recent annual report, Dana's inventory note indicated the following:

Dana changed its method of accounting for inventories effective January 1 . . . to include in inventory certain production-related costs previously charged to expense. This change in accounting principle