Case Study: Inventory Accounting

by Sophia

WHAT'S COVERED

This tutorial will cover the application of inventory accounting methods in the context of a case study, using a hypothetical merchandising company.

Our discussion breaks down as follows:

1. Case Study: Legacy Clothing

The subject company for our case study is called Legacy Clothing. Legacy Clothing is a sole proprietorship, which is a company that is owned by a single individual, and where that individual and the business are legally treated as the same.

The purpose of Legacy Clothing as a business is to own and operate clothing/merchandise stores. It is similar to a department store chain, selling men's, women's, and children's clothing and other related items. Legacy Clothing has locations throughout Washington, DC, and they have a staff of 50 people employed in their stores.

Legacy Clothing	
Type of company	Sole proprietorship
Business purpose	Own and operate clothing/merchandise stores
Business location(s)	Washington, D.C. Staff of 50 people

Since Legacy Clothing is a merchandising company, they need an inventory accounting method for the following reasons:

- *Inventory management*: To track inventory to help them understand where money is being spent, as well as maintain appropriate inventory levels
- *Accurate reporting*: To record and track accurate inventory amounts and, in turn, helps in providing accurate reporting
- *Perform analysis*: To easily perform analysis to understand what's going on with the inventory

2. Case Study: Inventory Accounting

When we are reviewing our financial statements and trying to understand the workings of our inventory, we need an inventory accounting method to perform any analysis. Which method should we use--FIFO, LIFO or weighted average?

In today's case study, we are going to discuss each of these three inventory accounting methods to determine which one Legacy Clothing should use.

2a. FIFO

Let's start with FIFO, which stands for First In First Out. In FIFO, the oldest goods--those that were purchased first--are the first to be sold and the newest goods remain in ending inventory. Goods are sold oldest to newest.

So, why should Legacy Clothing use this method? Well, FIFO resembles the physical flow of goods; therefore, the flow of their merchandise will typically mimic FIFO, meaning the first units that they bring in are generally going to be the first units that they sell.

2b. LIFO

Let's continue with the second option for Legacy Clothing, LIFO, which is an acronym for Last In First Out. Under LIFO, the newest goods--those purchased last--are the first to be sold and oldest goods remain in ending inventory.

Now, LIFO might be a good option for Legacy Clothing because it matches current costs with current revenues. It matches the cost of items that are being sold with the current revenue that is being recognized, meaning the most recent items that they purchased are the first to go out the door.

2c. Weighted Average Method

The third option is the weighted average method. The matter of which goods are the first to be sold or which remain in ending inventory is of no concern in the weighted average method. Under the weighted average method, inventory is determined by looking at the total cost of all the units as well as the total units--regardless of when they are sold--to calculate the average cost per unit.

Again, why would Legacy Clothing want to use this method? Well, it's a simpler method. Because inventory is so complex, it's difficult to know and monitor and measure the exact flow of inventory. Are those first items that you bring in actually the items that you're selling first, or are your most recent purchases being sold first? The weighted average method helps to take away some of these complexities by looking at the total units and the total cost.

THINK ABOUT IT

Now that we've discussed all three inventory accounting methods, which option do you think Legacy Clothing should use? Well, the best option for Legacy Clothing is going to be FIFO, or First In First Out, because FIFO resembles the physical flow of the merchandise.

Legacy Clothing, being a department store, is going to push sales by taking those first items that they get into the store and trying to sell them first. They will want to match the first ones in with the first ones out.

SUMMARY

Today we introduced our **case study** company called **Legacy Clothing**, a department store selling men's, women's, and children's clothing and other related items. We discussed several **inventory accounting methods** as they relate to our subject company, Legacy Clothing, looking at **FIFO**, **LIFO**, and the **weighted average method**. We determined that because the physical flow of merchandise is the most important consideration for Legacy Clothing, FIFO is the best inventory accounting method for them to use.

Source: Adapted from Sophia instructor Evan McLaughlin.