

Visual Learning Maps

Introductory Financial Accounting



Click to Go to the Website

VIRTUAL TEXT BOOK

Periodic and Perpetual Merchandise Inventory Methods – 1 of 5

There are two inventory methods for accounting for merchandise – Periodic and Perpetual.

Both methods use physical counts of merchandise inventory.

Under the Periodic system, the physical count is used as part of the calculation of the Cost of Goods Sold at the end of the accounting period.

Under the Perpetual system, the physical count is used to check the accuracy of the accounting records. This could be once a year or once a week. When the physical count of inventory shows differences from the records; the records must be adjusted to reflect reality, and management must investigate why they are different.

Example of What to Do When a Difference is Determined:

- If you are in the merchandise business of selling sand, and a 1% difference is determined between the physical count and the accounting records – you wouldn't be driven to investigate quickly and intensely.
- If you are in the merchandise business of selling expensive jewellery and watches –and a 1% difference is determined – an investigation would begin immediately.

The more valuable, attractive and portable inventory items are – the more often they are counted and compared to the inventory records.

If you were in the real estate business, the merchandise you would be selling could be only land; you would not have to count the lots often because, although your inventory is attractive and valuable – **it is not portable.**

In a merchandise operation where there are numerous products on display, differences between the physical count and the records can arise due to:

- paperwork processing errors
- shoplifting (theft out the front door)
- shrinkage (theft out the back door)
- other factors depending on the business (in the sand business – the wind)

Inventory Methods – 2 of 5 – Periodic & Perpetual Systems

The Periodic Method uses the “Purchases” account to record all inventory acquired from suppliers. At the end of the accounting period (month, quarter or year), the count of the inventory occurs. This count is the “closing inventory.” The word “Purchases” means a specific account that records expenditure amounts for goods or merchandise bought from suppliers that are then to be resold to customers.

Expenditures for merchandise inventory include two components:

1. The cost of the goods or merchandise; and
2. The cost of shipping the goods, called “**Freight In (or Transportation In)**,” when the goods are FOB shipping point.

What FOB Means

FOB means **Free On Board**.

FOB shipping point means that the sales contract stipulates that the supplier’s price is for the goods at the supplier’s location, and the buyer will thus be required to pay the freight / shipping costs. The buyer must arrange and pay for shipping the merchandise to whatever location is desired. These Freight In (or Transportation In) costs are always recorded to the Purchases account because they are considered as part of the cost of inventory. In other words, the cost of shipping the merchandise is explicitly attached to the cost of the merchandise and is therefore booked to the Purchases account.

FOB destination point means that the sales contract stipulates that the supplier’s price is for the goods at the buyer’s location, therefore the supplier will thus be required to pay the freight / shipping costs. The supplier must arrange and pay for shipping the merchandise to whatever location is desired by the buyer. The shipping costs may be included in the price of the merchandise or may be shown separately on the supplier’s invoice. Either way, the buyer records the total amount to the Purchases account.

In other words...the FOB tag determines who pays for the shipping – the supplier or the purchaser.

Inventory Methods – 3 of 5 – Periodic & Perpetual Systems

The Periodic Inventory Method



- Always uses the 'Purchases' account to record all acquisitions of goods that are to be sold to customers
- Never records bookkeeping entries when merchandise is sold to customers
- Always takes a physical count of merchandise inventory at the end of the accounting period (month, quarter, year); then determines the cost of the inventory on hand - called "**Closing Inventory**" or "**Ending Inventory**"
- Always calculates the Cost of Goods sold using the closing inventory

Who Uses the Periodic Method?

- Merchandisers in smaller operations not dealing in highly expensive items
- Merchandisers in smaller operations where the owners have total control of the inventory
- Operations selling bulk goods such as gravel & sand

Why?

Perpetual Inventory Systems incur more cost because of much more paper work processing; or costly equipment (scanners, computers) to keep track of every single inventory purchase sales transaction.

Large retailers and wholesalers do not use the Periodic Method

Periodic and Perpetual Merchandise Inventory Methods – 4 of 5

The Perpetual Inventory System



- Never uses the Purchases account
- Always records bookkeeping entries when merchandise is received from suppliers via the balance sheet inventory account
- Always records the reduction in the balance sheet inventory account when merchandise is sold AND records the cost of goods sold at the same time
- Always takes a physical count of merchandise inventory at the end of the accounting period (month, quarter, year) called "**Closing Inventory**" or "**Ending Inventory**"; then compares the count to the balance sheet account figure
- Always adjusts the balance sheet account to the inventory count
- Always compares the count to the records to determine if an investigation of the differences is required

Who Uses the Perpetual Method?

- Large Merchandisers – purchases of inventory use either data entry or scanners, “beep,” to record increases in the inventory account; and either data entry or “beep” at the check out using bar codes (UPC: **U**niversal **P**roduct **C**ode) to record the sale, reducing the inventory account and recording the cost of goods sold – such as the grocery business, clothing business, pharmacies, toy business; hardware, computer, plumbing, electrical supplies businesses – and so on
- Smaller merchandisers where individual inventory items are expensive, attractive and portable- such as the jewellery business
- Businesses that have no “beep” but often want to know inventory levels, such as vehicle dealerships and lumber merchants.

Why?

The cost of the perpetual system is worthwhile because knowing the inventory details on a daily basis is critical to the business operation.

Periodic and Perpetual **Merchandise Inventory Methods – 5 of 5** Accounting Entries – **PERIODIC Inventory System...**

Accounting Entries – **Purchases & Sales**

Example: a business buys merchandise “on account” from a supplier, 9 items @ \$100 each = \$900 on June 1, and sells 2 items to a customer for cash at \$150 each on June 5 = \$300.

	<u>Debit</u>	<u>Credit</u>
June 1 – record the purchase on account		
Purchases	900	
Accounts payable		900
June 5 – record the sale		
Cash	300	
Sales		300

Accounting Entries – **PERPETUAL Inventory System...**

Accounting Entries **Purchases & Sales**

Same example as above

June 1 – record the purchase on account		
Inventory	900	
Accounts payable		900
June 5 – record the cash sale		
Cash	300	
COGs	200	
Inventory (2 X \$100)		200
Sales		300

**See: Class Notes “Purchase Discounts, Returns & Allowances”
for Accounting Entries under both inventory systems**