Valuation of Inventories

Section A Fundamentals of Accountancy, Chapter 4

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### Learning Objectives

- Meaning of Inventory
- Types of Inventories
- Inventory valuation
- Basis of Inventory Valuation
- Valuation Inventory Techniques
  - FIFO (First in first out) Method
  - LIFO (Last in first out) Method
  - Average Price Method
  - Weighted Average Price Method
Learning Objectives

Non-Historical cost methods

Inventory Record Systems
• Periodic Inventory System
• Perpetual Inventory System

Stock Taking

MCQ
Inventory can be defined as tangible assets:

Held for sale in the ordinary course of business;

In the process of production for such sale;

In the form of materials or supplies to be consumed in the production process or in the rendering of services.
Types of Inventories

In case of manufacturing Concerns

- Raw Material
- Work in Progress
- Finished Goods
- Stores and Supplies

In case of Trading Concern

- Finished Goods
Determination of income

• The valuation of inventory is necessary for determining the true income earned by a business entity during a particular period to determine gross profit, cost of goods sold is matched with revenue of the accounting period.
Inventory valuation is useful to:

- Determination of income
- Ascertainedment of Financial Position
- Liquidity analysis
- Statutory Compliance
Cost of goods sold is calculated as follows

- Opening stock: XXXX
- Add Purchases: XXXX
- Add Direct expenses: XXXX
- Less Closing stock: XXXX

Cost of goods sold: XXXX
Impact of Inventory valuation on the income determination

When closing inventory is overstated, net income for the accounting period will be overstated.

When opening inventory is overstated, net income for the accounting period will be understated.
While finalizing the current year’s profit, the company realized that there was an error in the valuation of closing stock of the previous year. In the previous year, closing stock was valued more by Rs.50,000. As a result
Inventory valuation

(a) Previous year’s profit is overstated and current year’s profit is also overstated

(b) Previous year’s profit is understated and current year’s profit is overstated

(c) Previous year’s profit is understated and current year’s profit is also understated

(d) Previous year’s profit is overstated and current year’s profit is understated

Ans. (d)
Ascertainment of Financial Position

• Inventories are classified as current assets. The value of inventory on the date of balance sheet is needed to determine the financial position of the business.
Inventory valuation

In case the inventory is not properly valued, the balance sheet will not disclose the truthful financial position of the business.
Inventory valuation:

Liquidity analysis

Inventory is classified as a current asset, it is one of the components of net working capital which reveals the liquidity position of the business.

Current ratio which studies the relationship between current assets and current liabilities is significantly affected by the value of inventory.
Revised Schedule VI of the Companies Act, 1956 requires valuation of each class of goods i.e. raw material, work-in-progress and finished goods under broad head to be disclosed in the financial statements. As per the requirements of the Accounting Standards, the financial statements should disclose...
The accounting policies adopted in measuring inventories, including the cost formula used, the total carrying amount of inventories and its classification appropriate to the enterprise. The common classification of inventories are raw materials; work-in-progress; finished goods; stores and spares and loose tools.
Inventories should be generally valued at the lower of Cost or Net Realizable Value (NRV)
Basis of Inventory Valuation

Cost

- The amount of expenditure incurred on acquisition of goods.
Basis of Inventory Valuation

Net Realizable Value:

- This 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.
Inventory, not ordinarily interchangeable

Inventory, ordinarily interchangeable
Valuation inventory Techniques

Inventory, ordinarily interchangeable

Historical cost Methods

Non-historical cost
Valuation inventory Techniques

Inventory, not ordinarily interchangeable

Specific identification Method
Valuation inventory Techniques

Historical cost Methods

- FIFO
- LIFO
- Average Price
- Weighted Average Price
- Base Stock Method
- Inflated Price Method
- Specific Identification Method
Valuation inventory Techniques

Non-historical cost Methods

- Standard cost
- Adjusted Selling Price
- Latest Purchase Price
Historical cost Methods

Costs of purchase including:

- duties and taxes (irrecoverable taxing authorities),
- freight inwards and other expenditure directly attributable to the acquisition of goods.
- Trade discounts, rebates,
- duty drawbacks and other similar items are deducted in determining the costs of purchase.
Specific Identification Method

- It attributes specific costs to identified goods and requires keeping different lots purchased separately to identify the lot out of which units in stock are left.
- (This method is generally used to ascertain the cost of inventories of items that are not ordinarily interchangeable)
FIFO (First in first out) Method

- The actual issue of goods is usually from the earliest lot on hand. The stock of goods on hand therefore, consists of the latest consignments. Thus, the closing in inventory is valued at the price paid for such consignments.
Illustration 1- A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

<table>
<thead>
<tr>
<th>Date</th>
<th>Quantity (units)</th>
<th>Price per unit</th>
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</thead>
<tbody>
<tr>
<td>Dec. 4</td>
<td>900</td>
<td>5.00</td>
</tr>
<tr>
<td>Dec. 10</td>
<td>400</td>
<td>5.50</td>
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<tr>
<td>Dec. 11</td>
<td>300</td>
<td>5.50</td>
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<tr>
<td>Dec. 19</td>
<td>200</td>
<td>6.00</td>
</tr>
<tr>
<td>Dec. 28</td>
<td><strong>800</strong></td>
<td><strong>4.75</strong></td>
</tr>
</tbody>
</table>

2,600

1600 units were issued during the month

Solution

The closing stock is 1,000 units and would consist of:

- 800 units received on 28th December @ 4.75 = 3800/-
- 200 units received on 19th December @ 6.00 = 1200/-
- 1000 units

Total = 5000/-
Goods issued are valued at the price paid for the latest lot of goods on hand which means stock of goods in hand is valued at price paid for the earlier lot of goods. LIFO method is based on an irrational assumption that inventories entering last in the stores are issued or consumed first. However, the flow of goods which is generally observed in business entities is contradictory to this assumption. Therefore, LIFO method is no longer adopted for valuing inventories.
LIFO (Last in first out) Method

Illustration 1- A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

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</tr>
<tr>
<td>Dec. 28</td>
<td>800</td>
<td>4.75</td>
</tr>
</tbody>
</table>

Total: 2,600 units

1600 units were issued during the month

Solution

The closing stock is 1,000 units and would consist of:

- 900 units received on 4th December @ 5.00 = 4500/-
- 100 units received on 10th December @ 5.50 = 550/-

Total: 5050/
Average price for computing value of stock is a very simple approach. (All the different prices are added together and then divided by the number of prices). The closing stock is then valued according to the price ascertained.
Average Price Method

Illustration 3- A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

<table>
<thead>
<tr>
<th>Date</th>
<th>Quantity (units)</th>
<th>Price per unit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 4</td>
<td>900</td>
<td>5.00</td>
</tr>
<tr>
<td>Dec. 10</td>
<td>400</td>
<td>5.50</td>
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<tr>
<td>Dec. 11</td>
<td>300</td>
<td>5.50</td>
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<tr>
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<td>200</td>
<td>6.00</td>
</tr>
<tr>
<td>Dec. 28</td>
<td>800</td>
<td>4.75</td>
</tr>
</tbody>
</table>

2,600 units were issued during the month.

Solution

The closing stock is 1,000 units and would consist of -

\[
\frac{5.00 + 5.50 + 5.50 + 6.00 + 4.75}{5} = 5.35 \text{ per unit}
\]

Hence closing stock is 5.35*1000 = 5350
However, it is more logical to compute weighted average price using the quantities purchased in a lot as weights. Under weighted average price method, cost of goods available for sale during the period is aggregated and then divided by number of units available for sale during the period to calculate weighted average price per unit.
Weighted Average Price Method

Thus

Weighted average price per unit =
Total Cost of goods available for sale during the period
Total number of units available for sale during the period

Closing stock = No. of units in stock X Weighted average price per unit
illustration 3- A manufacturer has the following record of purchases of a condenser, which he uses while manufacturing radio sets:

<table>
<thead>
<tr>
<th>Date</th>
<th>Quantity (units)</th>
<th>Price per unit</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 4</td>
<td>900</td>
<td>5.00</td>
<td>4500</td>
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<tr>
<td>Dec. 10</td>
<td>400</td>
<td>5.50</td>
<td>2200</td>
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<tr>
<td>Dec. 11</td>
<td>300</td>
<td>5.50</td>
<td>1650</td>
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<tr>
<td>Dec. 19</td>
<td>200</td>
<td>6.00</td>
<td>1200</td>
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<tr>
<td>Dec. 28</td>
<td>800</td>
<td>4.75</td>
<td>3800</td>
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<td></td>
<td>2,600</td>
<td></td>
<td>13350</td>
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</tbody>
</table>

1600 units were issued during the month

Solution

The closing stock is 1,000 units and would consist of –

Weighted average cost per unit will be $13350/2600 = 5.13

$1000 \times 5.135 = \text{Rs. 5135/-}$
Best Method

Generally in Practice FIFO and Average Price Method are popular among the business entities.
This method is also called retail inventory method. The use of this method is appropriate for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage of gross margin.

Contd....
The percentage used takes into consideration inventory which has been marked below its original selling price. An average percentage for each retail department is often used. The calculation of the estimated gross margin of profit may be made for individual items or groups of items or by departments, as may be appropriate to the circumstances.
There are two principal systems of determining the physical quantities and monetary value of inventories sold and in hand. One system is known as ‘Periodic Inventory System’ and the other as the ‘Perpetual Inventory System’.
Periodic inventory system is a method of ascertaining inventory by taking an actual physical count (or measure or weight) of all the inventory items on hand at a particular date on which inventory is required. It is because of actual physical count that the system is also called physical inventory system.
Periodic Inventory System

The cost of goods sold is determined as shown below:

- Opening inventory (known)  
  + Purchases (known)  
  - closing inventory (physically counted)  

Cost of goods sold.
Advantages

Periodic inventory system is simple and less expensive.
Limitations:

- Physical stock taking more than once a year
- More expensive.
- Physical count of goods requires closure of normal operations of business.
- As cost of goods sold is taken as residual figure, it includes loss of goods during the year.
- Inventory control is not possible under this system.
Perpetual inventory system is a system of recording inventory balances after each receipt and issue. In order to ensure accuracy of perpetual inventory records, physical stocks should be checked and compared with recorded balances.

Under this system, cost of goods issued is directly determined and stock of goods is taken as residual figure with the help of stock ledger in which flow of goods is recorded on continuous basis.
The basic feature of this system is the maintenance of stock ledger to have records of goods on continuous basis. Perpetual inventory system helps to overcome the limitations of periodic system. As stock is taken as residual figure, it includes loss of goods. However, the main limiting factor is the cost of using this system.
Distinction

Periodic inventory System
- This system is based on physical verification.
- This system provides information about stock and cost of goods sold at a particular date.
- This system determines inventory and takes

Perpetual inventory System
- It is based on book records.
- It provides continuous information about stock and cost of sales.
- It directly determines cost of goods sold and computes stock as balancing figure.
Periodic inventory System

- Cost of goods sold includes loss of goods as goods not in stock are assumed to be sold.
- Under this method, inventory control is not possible.

Perpetual inventory System

- Closing inventory includes loss of goods as all unsold goods are assumed to be in Inventory
- Inventory control can be exercised under this system.
Distinction

**Periodic inventory System**

- This system is simple and less expensive.
- Periodic system enquires closure of business for counting of stock.

**Perpetual inventory System**

- It is costlier method.
- Inventory can be determined without affecting the operations of the business.
Normally all operations are suspended for one or two days during the financial year and physical inventory is taken for everything in the godown or the store periodically.
Often, stock taking cannot be carried out on the closing day. It is carried out a few days later or sometimes even a few days earlier. In such a case, the actual value of the stock must be so adjusted as to relate it to the end of the year concerned.
For doing so, it will be necessary to take into account the goods that have come in (purchases and sales returns) and those that have gone out (sales and purchase returns) during the interval between the close of the year and the date of actual stock taking.
Calculation of closing stock if physical stock taking is done during the last week of the financial year

Stock as on say 25/03/2013 XXX

Add purchase (less return) from
25/03/2013 to 31/03/2013 XXX

Less Sales (less return) XXX

25/03/2013 to 31/03/2013

Stock as on 31/03/2013 XXX
Stock Taking

Calculation of closing stock if physical stock taking is done during the first week of next the financial year

Stock as on say 07/04/2013
Less purchase (less return) from
01/04/2013 to 07/04/2013
Add Sales (less return)
01/04/2013 to 07/04/2013
Stock as on 31/03/2013
A trader prepared his accounts on 31st March, each year. Due to some unavoidable reasons, no stock taking could be possible till 07th April, 2013 on which date the total cost of goods in his godown came to Rs. 50,000. The following facts were established between 31st March and 7th April, 2013.
(i) Sales Rs. 41,000 (including cash sales Rs. 1,000)
(ii) Purchases Rs. 5,034 (including cash purchases Rs. 1,990)
(iii) Sales Return Rs. 1,000.

Goods are sold by the trader at a profit of 20% on sales.

You are required to ascertain the value of inventory as on 31st March, 2013
**Question**

Value of stock as on 7\(^{th}\) April, 2013  \(\text{Rs. 50,000.00}\)

Add Cost of goods sold during the period from 1\(^{st}\) April, 2013 to 07\(^{th}\) April, 2013

Sales \((41,000 - 1,000)\)  \(40,000.00\)

Less: Gross Profit (20% of 40,000)  \(8,000.00\)  \(32,000.00\)

Less Purchases during the period from \(5,034.00\)

Closins Stock as on 31\(^{st}\) March, 2013  \(\text{Rs. 76,966.00}\)
Question

Use the following information to calculate the value of inventory on hand on 31 March under FIFO (First in First Out Method)?

1  Mar Opening Stock  60 units @ Rs.15.00 per unit
5  Mar Purchase 140 units @ Rs. 15.50 per unit
14 Mar Sale 190 units
27 Mar Purchase 70 units @ Rs. 16.00 per unit
29 Mar Sale 30 units
## Solution FIFO Method

<table>
<thead>
<tr>
<th>Date</th>
<th>Purchases</th>
<th></th>
<th></th>
<th>Sales</th>
<th></th>
<th></th>
<th>Balance</th>
<th></th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Units</td>
<td>Unit Cost</td>
<td>Total</td>
<td>Units</td>
<td>Unit Cost</td>
<td>Total</td>
<td>Units</td>
<td>Unit Cost</td>
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<td>1-Mar</td>
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<td>5</td>
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<td>15.50</td>
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</tr>
</tbody>
</table>

1-March: 15 units x 900 = 15,000
2-March: 140 units x 15.50 = 2,170
10 units x 15.50 = 155

3-March: 130 units x 15.50 = 2,015
20 units x 15.50 = 310

4-March: 50 units x 15.50 = 775
20 units x 16.00 = 320

5-March: 50 units x 16.00 = 800
Use the following information to calculate the value of inventory on hand on 31 March under LIFO (Last in First Out Method)?

1  Mar Opening Stock  60 units @ Rs.15.00 per unit
5  Mar Purchase 140 units @ Rs. 15.50 per unit
14 Mar Sale 190 units
27 Mar Purchase 70 units @ Rs. 16.00 per unit
29 Mar Sale 30 units
## Solution LIFO Method

<table>
<thead>
<tr>
<th>Date</th>
<th>Purchases</th>
<th>Sales</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Units</td>
<td>Unit Cost</td>
<td>Total</td>
</tr>
<tr>
<td>1-Mar</td>
<td>60</td>
<td>15.00</td>
<td>900.00</td>
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<tr>
<td>5</td>
<td>140</td>
<td>15.50</td>
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<td>140</td>
<td>15.50</td>
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<td>50</td>
<td>15.00</td>
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<td>16.00</td>
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<td>70</td>
<td>16.00</td>
<td>1120.0</td>
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<td>29</td>
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<td>16.00</td>
<td>640.00</td>
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<td>31</td>
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</tbody>
</table>
Use the following information to calculate the value of inventory on hand on 31 March under Weight Average Method?

1  Mar Opening Stock  60 units @ Rs.15.00 per unit
5  Mar Purchase 140 units @ Rs. 15.50 per unit
14 Mar Sale 190 units
27 Mar Purchase 70 units @ Rs. 16.00 per unit
29 Mar Sale 30 units
## Solution Weighted Average Method

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<tr>
<td>31</td>
<td></td>
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</tbody>
</table>
Conclusion

Closing Stock under various method is-

FIFO

50 X Rs. 16 = Rs.800.00

LIFO

10 X Rs. 15 = Rs.150.00

40 X Rs.16 = Rs.640.00

50 X Rs.16 = Rs.790.00

Weighted Average Cost 50X Rs.15.92 = Rs.796.00
Question Time

MCQ’s
If Cost of goods sold is Rs. 80,700, Opening stock Rs.5,800 Closing stock Rs.6,000 then amount of purchase will be-

- (a) Rs.80,500
- (b) Rs.74,900
- (c) Rs.74,700
- (d) Rs.80,900

Answer. (d) Rs.80,900
The total cost of goods available for sale with a company during the current year is Rs.12,00,000 and the total sales during the period are Rs.13,00,000. If the gross profit margin of the company is 33 1/3% on cost, the closing inventory during the current year is

- (a) Rs.4,00,000
- (b) Rs. 3,00,000
- (c) Rs.2,25,000
- (d) Rs. 2,60,000.

Answer. (c) Rs. 2,25,000
while finalizing the current year’s profit, the company realized that there was an error in the valuation of closing stock of the previous year. In the previous year, closing stock was valued more by Rs.50,000. As a result

(a) Previous year’s profit is overstated and current year’s profit is also overstated

(b) Previous year’s profit is understated and current year’s profit is overstated

(c) Previous year’s profit is understated and current year’s profit is also understated

(d) Previous year’s profit is overstated and current year’s profit is understated

Ans. (d) Previous year’s profit is overstated and current year’s profit is understated
An overstatement in the value of closing stock overstates all of the following except

a) Net income

b) Current assets

c) Capital of the business

d) Cost of goods sold

Ans. d) Cost of goods sold
Which one of the following methods of inventory costing yields highest taxable income?

a) FIFO
b) LIFO
c) AVCO or average cost
d) Standard cost method

Ans. (a) FIFO
Which one of the following inventory costing methods is supposed to issue the most recently purchased goods?

- a) FIFO method
- b) AVCO or average cost method
- c) LIFO method
- d) Moving average

Answer: c) LIFO method
MCQ.7: All of the following are the methods of inventory costing except

- a) FIFO
- b) LIFO
- c) AVCO or average cost
- d) Stock take

Answer d) Stock take
MCQ.8: Opening inventory + Net purchases = What?

a) Ending inventory
b) Closing stock
c) Cost of goods manufactured
d) Cost of goods available for sale

Answer: d) Cost of goods available for sale
Gross profit is 25% on total sales and cost of goods sold amounts to Rs. 750. Which of the following is the amount of gross profit?

- a) Rs. 187.70
- b) Rs. 200.00
- c) Rs. 150.00
- d) Rs. 250.00

Answer: d Rs. 250.00
MCQ. 10: NRV or net realizable value of inventory is the expected selling price or market value less-

a) Carry value of the inventory
b) expenses necessary to complete sale
c) Cost of the stock
d) replacement cost

Answer. b) expenses necessary to complete sale
If a company is experiencing continuous cost increases for the merchandise that it purchases, which cost flow assumption will result in the least amount of profit and the least amount of income tax expense?

• (a) FIFO
• (b) LIFO
• (c) Average
• (d) Weighted Average

Answer. (b) LIFO
MCQ. 12: A company in the computer industry is experiencing continuously lower costs. Which cost flow assumption will result in less income tax expense for this company?

(a) FIFO
(b) LIFO
(c) Average
(d) Weighted Average

Answer: (a) FIFO
MCQ.13: Which accounting concept is most reflected in the following accounting policy ‘Inventories are stated at the lower of average purchase cost and net realisable value?'

a) Prudence

b) Consistency

c) Matching

d) Money measurement

Answer. a) Prudence
MCQ.14: B & Co write off its inventory by Rs. 15,000. As a result, its:

- a) Cost of goods available for sale is decreased
- b) Cost of goods available for sale is increased
- c) Its current assets are decreased
- d) Its stockholders' equity is increased

Answer: c) Its current assets are decreased
MCQ. 15: Goods available for sale is equal to:

a) Cost of goods sold plus ending inventory.

b) Cost of goods sold minus ending inventory.

c) Beginning inventory plus cost of goods sold.

d) Beginning inventory plus purchases minus cost of goods sold.

Answer. a) Cost of goods sold plus ending inventory.
O & Co having beginning inventory of Rs.25,000 and an ending inventory of Rs.40,000. Its cost of goods sold for the year was Rs.485,000. What was the amount of purchases that it made for the year?

- a) Rs.4,70,000
- b) Rs.5,00,000
- c) Rs.5,25,000
- d) Rs.5,30,000

Answer: b) Rs.5,00,000
MCQ.17: The specific identification method of inventory valuation is based on the

- a) actual cost of each item of merchandise.
- b) average cost of each item of merchandise.
- c) earliest cost of each item of merchandise
- d) latest cost of each item of merchandise

Answer. a) actual cost of each item of merchandise.
MCQ.18:
The weighted average cost of an inventory item is calculated by dividing the:

a) sum of the unit cost on the purchase invoices by the number of units purchased.

b) cost of goods available for sale by the number of units on the ending inventory.

c) cost of goods available for sale by the number of units available during the period.

d) cost of goods sold by the number of units available during the period.

Answer. c) cost of goods available for sale by the number of units available during the period.
MCQ. 19: Which of the following is not a primary goal of inventory management?

a) Obtaining the lowest cost of inventory.

b) Ensuring sufficient quantities of inventory are available to meet customers' needs.

c) Ensuring inventory quality meets customers' expectations and company standards.

d) Minimizing the costs of acquiring and carrying inventory.

Answer. a) Obtaining the lowest cost of inventory.
Thank you