AFA 100: Lower of Cost and Market Rule

TRAIN TO LEARN EFFECTIVELY: TIP SHEETS

What is the Lower of Cost and Market Rule?

Ending inventory is recorded and reported at its cost to the firm. This means that inventory reported on the balance sheet does not reflect its retail value. Does the failure to reflect the current retail value of inventory lead to a distorted view of a firm's financial position?

There is one circumstance in which IFRS/GAAP requires a firm to adjust its inventory to its fair market value. IFRS/GAAP requires that inventory must be carried on the books and reflected on the balance sheet at the **LOWER OF COST OR MARKET VALUE (LCM).** This means that inventory cannot be adjusted up to fair market value, but must be adjusted when its fair market value declines below its cost.

When would the market value of inventory drop below its cost?

- Obsolescence
- Spoilage
- Changes in customer preferences
- Poor production and purchasing decisions

If a business failed to adjust the carrying value of its inventory downward in such circumstances, its economic condition reflected on the balance sheet definitely would be distorted. In this case, the distortion would result in overstating a company's value, rather than understating it.

After calculating the cost of inventory, a comparison is made to market value. The **LOWER** of cost or market value is selected as the value of inventory. Why would the market drop below the cost of inventory?

- Technology
- Style
- Falling value of the dollar

What is market value?

(a) REPLACEMENT COST: the amount the company would have to pay at the present time for the goods in question;

OR

(b) NET REALIZABLE VALUE: the estimated selling price in the ordinary course of business LESS the estimated costs of selling the inventory.

LCM and GAAP

Conservation: choose the method least likely to overstate assets and net income.

When is Lower of Cost and Market used?

After FIFO or LIFO or Weighted Average Cost or Specific Identification has been used to determine the cost of inventory.

How can Lower of Cost and Market be applied?

There are 3 ways:

(1) Inventory item by inventory item;
(2) Categories of inventory (e.g. computers, equipment, etc.);
(3) Total value of all inventory items

The most common way to apply LCM is #3 - by total value of all inventory items. In fact, this is the method that must be used for income tax purposes.

If MARKET VALUE is <u>less than</u> COST VALUE, the following journal entry is recorded:

DR: Loss from Write-Down of Inventory (Expense from Income Statement)
    CR: Merchandise Inventory (Asset from Balance Sheet)

Remember if Cost is less than Market, we do not have a Write Down and there is NO journal entry required. We keep the ending inventory value AS IS.

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Example 1:

Example 1:			
	Cost	Market	LCM
Television Sets:			
Consoles	$60,000	$55,000	$55,000
Portables	$45,000	$52,000	$45,000
Total	$105,000	$107,000	$105,000
Video Equipment:			
Recorders	$48,000	$45,000	$45,000
Movies	$15,000	$14,000	$14,000
Total	$63,000	$59,000	$59,000
Total Inventory	$168,000	$166,000	$166,000

Prepare a schedule which shows the value of the ending inventory by applying the lower of cost and market basis using all 3 ways:

Ending Inventory	
Method 1: Inventory Item by Inventory Item	$159,000
Method 2: Categories of Inventory	$164,000
Method 3: Total Value of All Inventory Items	$166,000

Example 2:

Example 2:

The controller of Lawn-Man Company is evaluating the alternative methods of applying the lower of cost and market basis of valuing ending inventory. The following information is available:

(a) Prepare a schedule which shows the value of the ending inventory by applying the lower of cost and market basis to total inventory.

	Cost	Market
Lawnmowers:		
Self-propelled	$19,000	$21,000
Push type	$25,000	$20,000
Total	$44,000	$41,000
Snowblowers:		
Manual	$38,000	$37,000
Self-start	$24,000	$26,000
Total	$62,000	$63,000
Total Inventory	$106,000	$104,000

Market < Cost

$104,000 < $106,000

Ending Inventory: $104,000

(b) Prepare the journal entry to record any inventory write down required.

Cost - Market = Write Down

106000 - 104000 = 2000

Since Market is LESS THAN Cost, there will be a write down and we must record it in a journal entry to adjust inventory according to the lower of cost and market rule.

DR	Loss on Write-Down of Inventory		$2,000	
	CR	Merchandise Inventory		$2,000

Remember if Cost is less than Market, there will be no write down and no journal entry is required.

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Example 3:

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Dalhat Company is preparing the annual financial statements dated December 31, 2001. Information about inventory stocked for regular sale follows:

(a) Calculate the valuation for the December 31, 2001, ending inventory using the lower of cost and market rule applied to total inventory.

Item	Quantity on Hand	Unit Cost When Acquired	Replacement cost (market) at year end
A	50	$25	$22
B	100	$55	$55
C	20	$75	$78
D	40	$50	$50

Ending Inventory:	Cost	Market
	=Quantity x Unit Cost	=Quantity x Replacement Cost
	10250	10160

Market < Cost

$10,160 < $10,250

Ending Inventory = 10160

(b) Prepare the journal entry to record any inventory write down required.

Cost - Market = Write Down

10250 - 10160 = 90

Since Market is LESS THAN Cost, there will be a write down and we must record it in a journal entry to adjust inventory according to the lower of cost and market rule.

DR	Loss due to Write-Down of Inventory		90	
	CR	Merchandise Inventory		90

Remember if Cost is less than Market, there will be no write down and no journal entry is required.

What if the economic situation goes back up after the Write Down?

If the market value goes up after a write down of inventory, the business can recover the loss up to a maximum cap of the original historical cost. When a company writes up the asset, the writeup is limited to the extent of any prior writedown.