Inventory Systems and Flow of Costs

The new Loafe cafe just recently opened up and they are as ready for a new school year as you are! Unfortunately, it's been years since their manager Tom was an accounting student, and he doesn't quite remember how to account for his store's inventory. One day, as you were leaving your Financial Accounting class, Tom stopped you and asked if you could help him out.

To help Tom, you first ask him if he wants to keep a **Perpetual** or **Periodic inventory system.** Because he isn't quite sure, you help him by comparing the two systems:

The **pros** of a **perpetual inventory system** include better control over inventories, inventory records that reflect real-time quantities of stock, and real-time reporting of gross margin and profits. However, this comes at the major **con** of additional administrative and accounting work in the office to maintain the inventory records.

On the other hand, the main **advantage** of a **periodic inventory system** is the simplicity in recording and accounting, as the system does not require an entry to be made for each sale. Instead, the Cost Flow equation is used once at the end of each period to determine the COGS and Inventory account balances. The COGS Cost Flow equation tells us that **COGS equals Beginning Inventory plus Inventory Purchases Made in the Period minus Ending Inventory**. However, this makes real-time reporting difficult, because there is a lack of control or insight on a business' inventory during the period which is a major **disadvantage**. The main benefit of this system is that it's cheaper to run. It requires less administrative work, and inventory costs are derived using the cost flow formula instead. However, it requires the company to keep track of additional and separate accounts for purchases, freight costs, returns, and discounts.

After your explanation, Tom considers what will be best for Loafe both financially and operationally. He decides that even though a perpetual system is more costly, he would want to keep a close eye on the inventory. He follows up by asking you how the transactions would look under the **perpetual system.**

Tom gives you a list of Loafe Cafe's financial activities for the month, and you quickly draft up the perpetual journal entries for him.

When recording sales in a **perpetual inventory system**, there are **two** journal entries required. **The first entry is to record sales.** When a company sells something and receives money, we have an increase in the cash account, and a corresponding increase in the sales revenue account. We record it as a debit to cash and a credit to sales revenue. Depending on the customer's payment method, the debit may not always be to the Cash account, and can sometimes appear as a debit to the Accounts Receivable account, should they choose to pay on something like a credit card.

The second entry is to record the Cost of the Goods Sold, which is also known as COGS. When a good is sold, there is an inventory outflow. When inventory leaves the store, we need to take it off our books by removing its value from the inventory account. We also need to remove the amount we spent to acquire that inventory. The Inventory account is an Asset account, so we decrease its balance by crediting the Inventory account. We also represent the cost of acquiring the inventory as an expense, by debiting the COGS account. Recall the matching principle applies here. Imagine we spent cash to buy coffee beans that we stock as inventory. That money spent does not show up as an expense yet. However, once we sell the coffee for revenue we need to represent that money spent as an expense incurred to produce the revenue of the coffee sold.

Let's apply what we just learned to Loafe's financial activities. Pause the video here to complete the journal entries and press play again to view the solutions.

Here's the solution.

After you're done, Tom thanks you for helping him out. Loafe is now on the **perpetual inventory system**, which will require Tom to update his inventory with each sale. Remember that traditionally, smaller businesses are more inclined to employ the Periodic Inventory System because it is more cost-efficient. Smaller businesses have smaller margins, so every dollar saved matters. However, because it sounds like Loafe would want updated records that reflect the true inventory at all times, you inform Tom that the solution is a **Perpetual Inventory System.**

Thank you so much for helping Tom sort out Loafe's books!