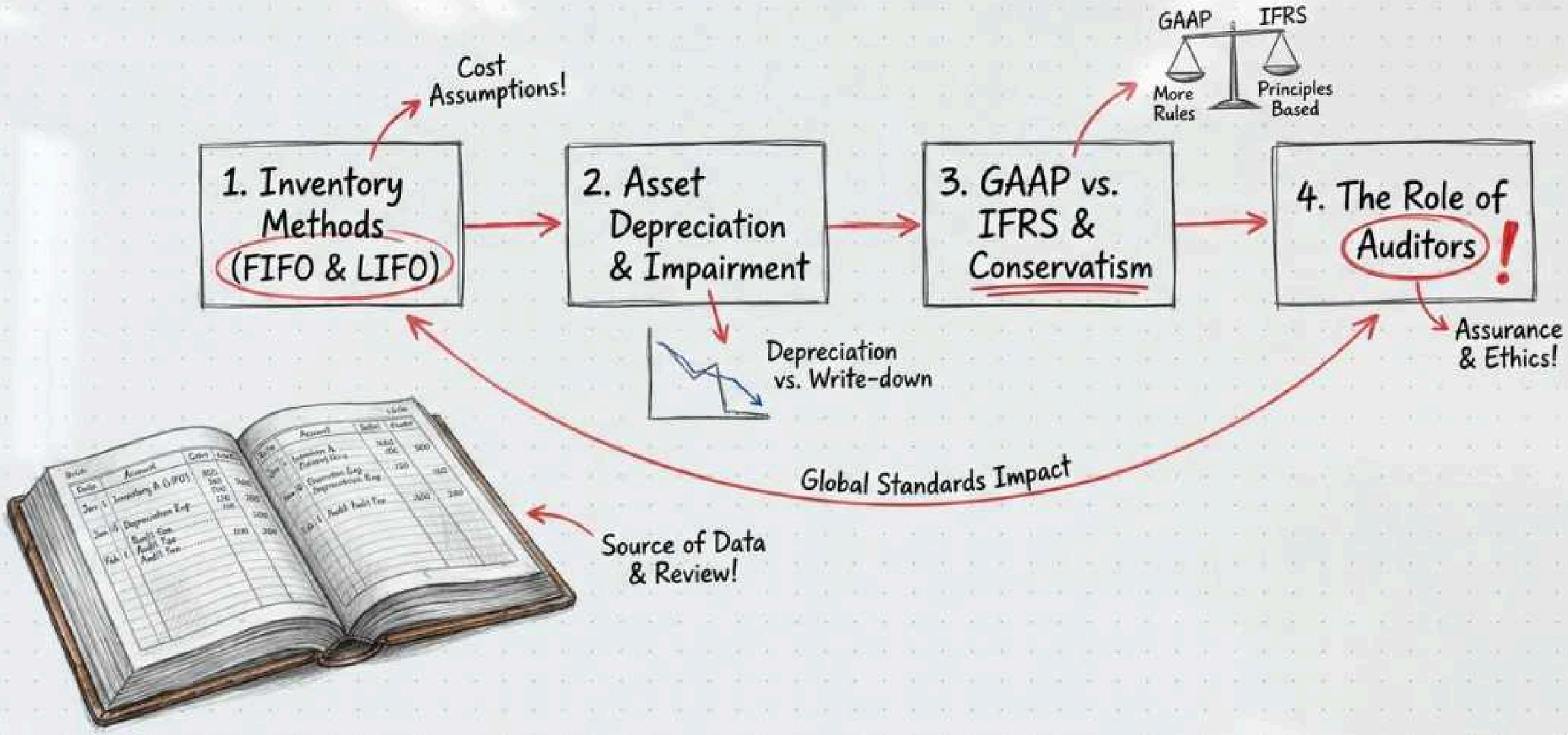
ACCT 201 B: Lecture 5 — Inventory, Depreciation, and Standards

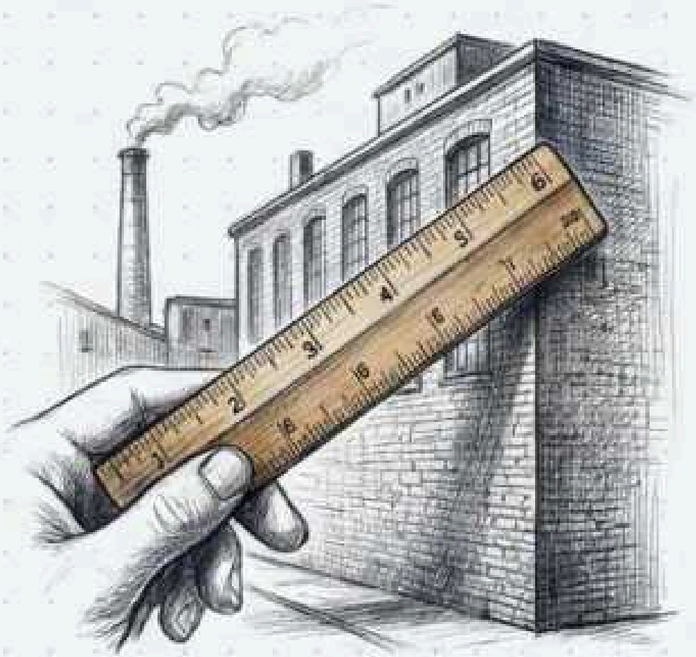
At a Glance.



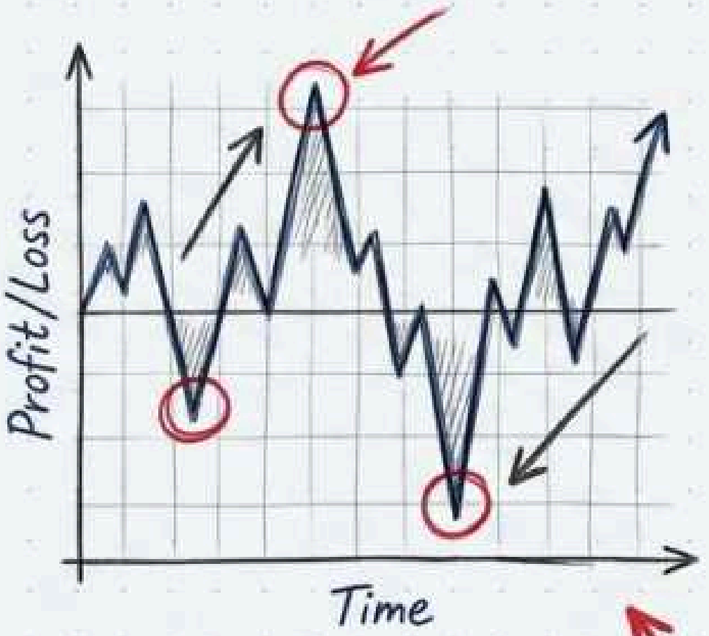
Gemini Notebook

¶ 5.1

Accounting must answer three fundamental questions



How do we measure the cost of inventory and long-lived assets?



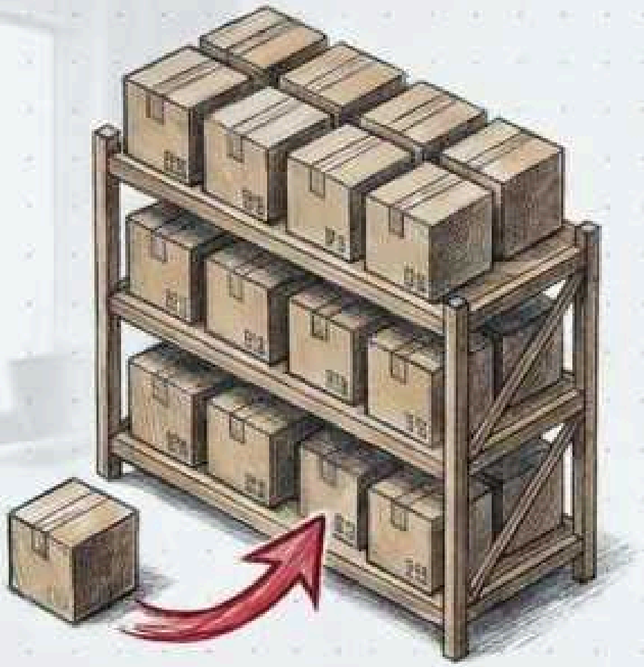
Why do accountants' choices and estimates matter so much?



Who sets the rules, and who checks that companies follow them?

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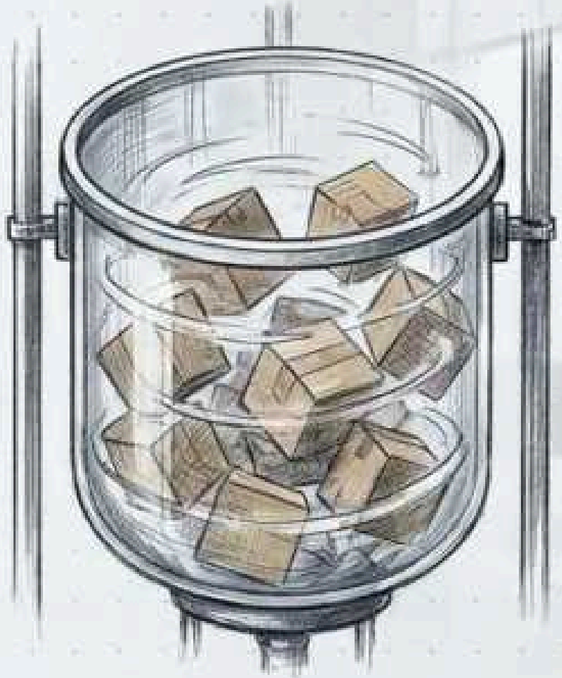
Assigning costs requires choosing an inventory method



First In, First Out (FIFO). The oldest costs are assigned to sales first.



Last In, First Out (LIFO). The newest costs are assigned to sales first.



Weighted Average. Costs are blended together across the inventory.

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The Bicycle Shop Proof shows how methods alter reality

¶ 5.3



Buy 1 @ $200. Buy 2 @ $300. Sell 1 @ $500.

FIFO

Revenue: $500

Minus COGS: $200 (The older, cheaper bike)

Profit: $300

LIFO

Revenue: $500

Minus COGS: $300 (The newer, expensive bike)

Profit: $200

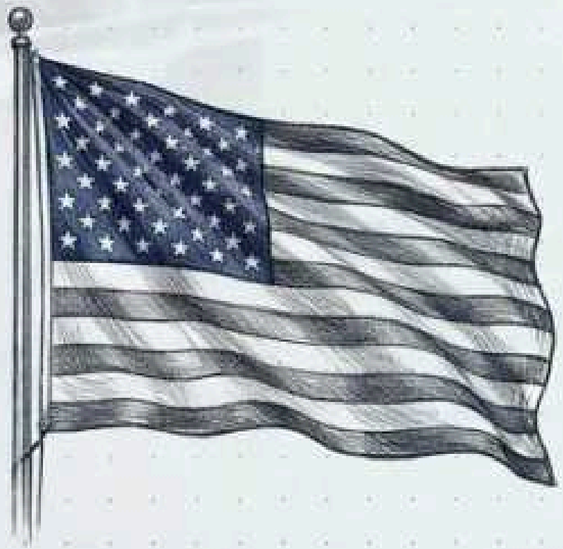
Same exact sale. Completely different profit.

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The economic and global impact of using LIFO

¶ 5.4

Rising Prices → LIFO Applied → Higher COGS → Lower Reported Profit → Lower Corporate Taxes



American Rules allow LIFO. This is why many US companies use it to save on taxes.

International Standards (IFRS) strictly prohibit LIFO.

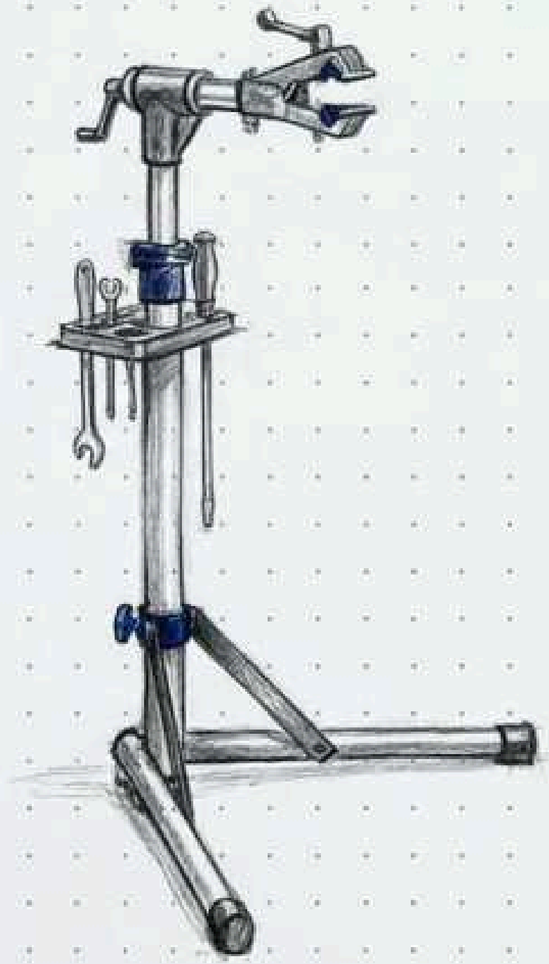


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Spreading out the cost of long-lived assets over time

¶ 5.5

Long-lived assets (machines, buildings) are spread over their useful life through depreciation.



$$\text{Depreciation} = \frac{\text{Cost} - \text{Expected Leftover Value}}{\text{Useful Life}}$$

$$= \frac{\$1{,}000 - \$0}{4 \text{ years}} = \$250 \text{ per year}$$

$250	$250	$250	$250

$1,000

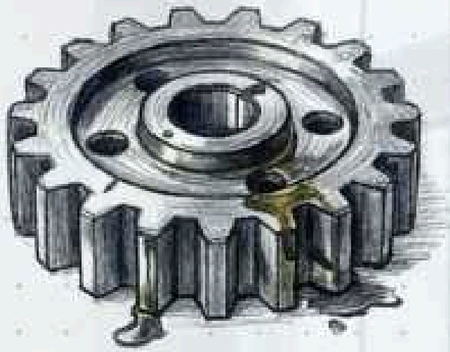
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¶ 5.6

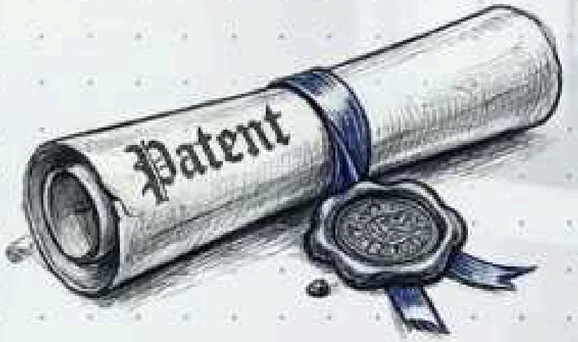
How different types of assets are consumed

Assets

- **Tangible Assets** (Machines/Buildings) → **Depreciation** (Methods include Straight-line or Declining balance, which charges more in early years)



- **Intangible Assets** (Patents) → **Amortization** (Costs are spread out similarly over a limited life)



- **Land** → **NO Depreciation** (Land does not wear out)

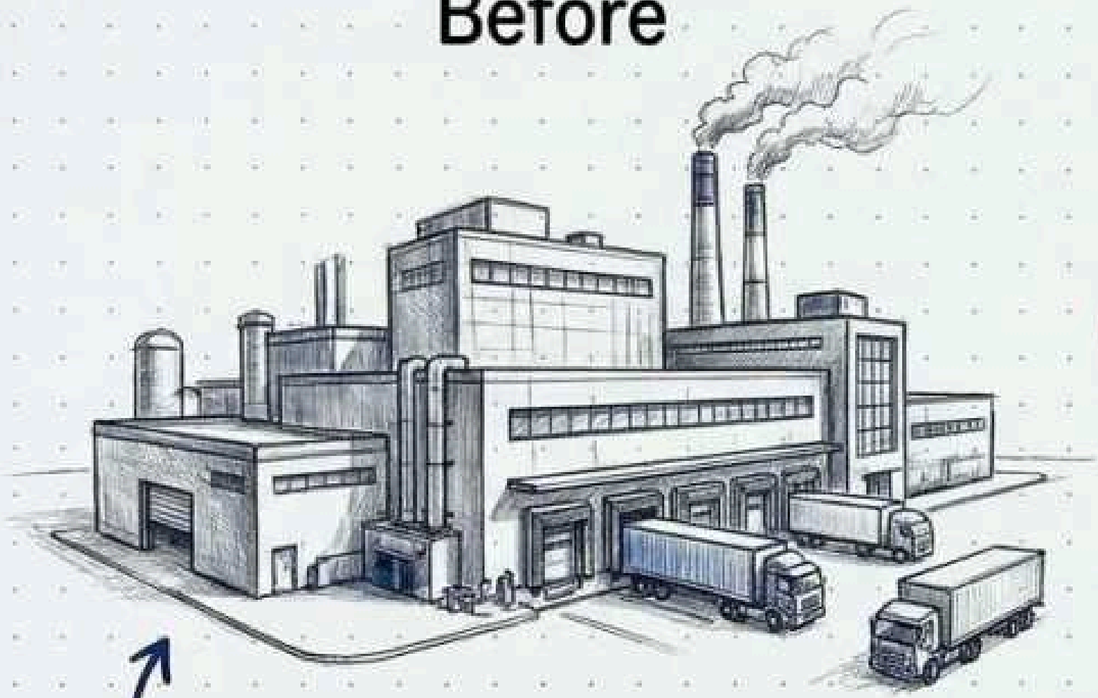


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¶ 5.7

The sudden reality of asset impairment

Before



Factory asset held at original historical value.

Obsolescence / New Technology

After



Asset is forcefully written down to its Recoverable Amount.

Impairment turns a year's profit into a large loss, but NO cash actually leaves the company.

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Accounting is an exercise in judgment and estimation

¶ 5.8



Small changes in these estimates = massive changes in profit.!

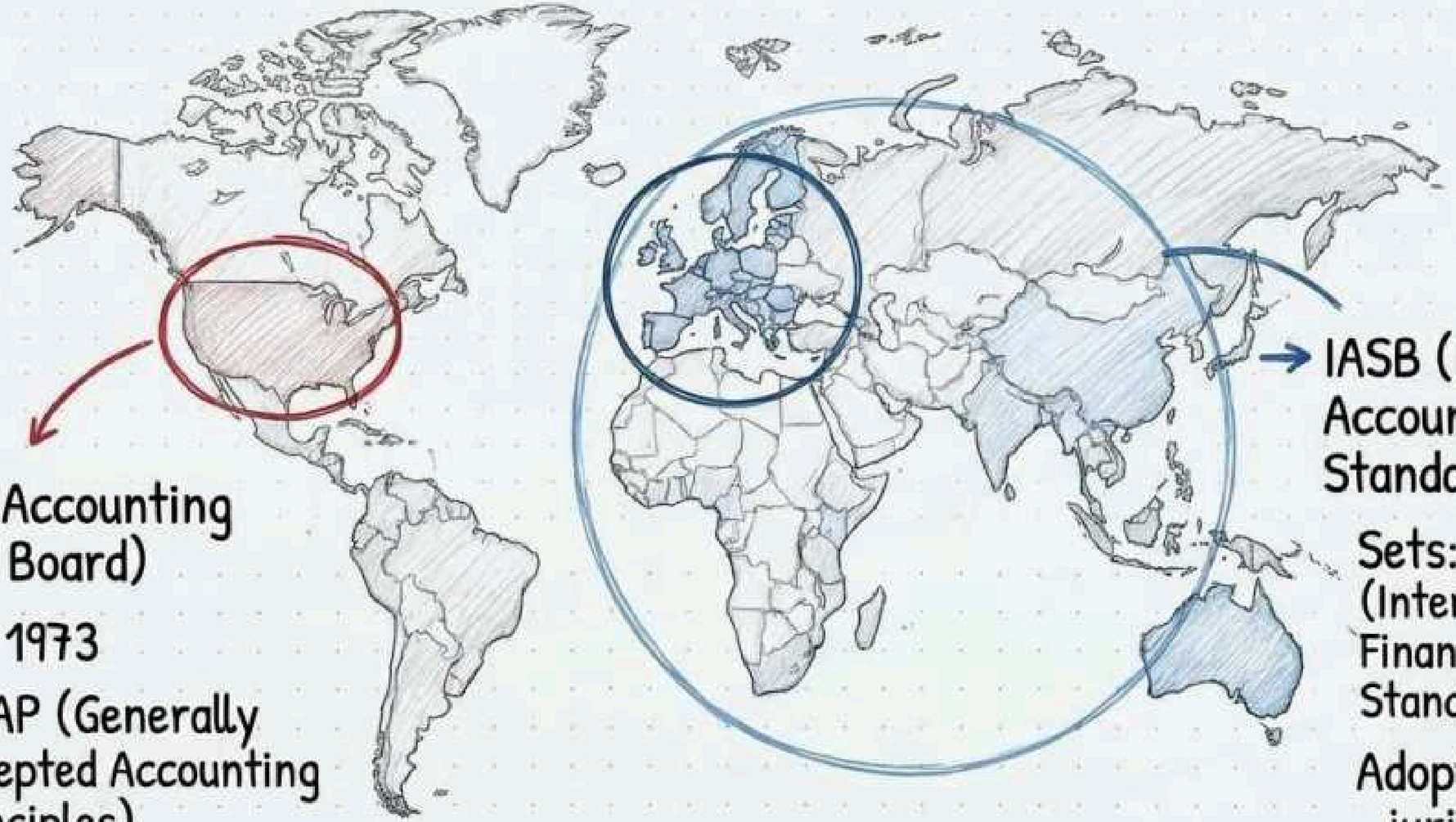


Because accounting involves judgment, readers MUST study the notes where estimates are explained.

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The independent boards that write the rules

¶ 5.9



→ **FASB**
(Financial Accounting Standards Board)

Founded: 1973

Sets: GAAP (Generally Accepted Accounting Principles)

→ **IASB** (International Accounting Standards Board)

Sets: IFRS (International Financial Reporting Standards)

Adopted by: 140+ jurisdictions.

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¶ 5.10

Two similar systems with different underlying philosophies

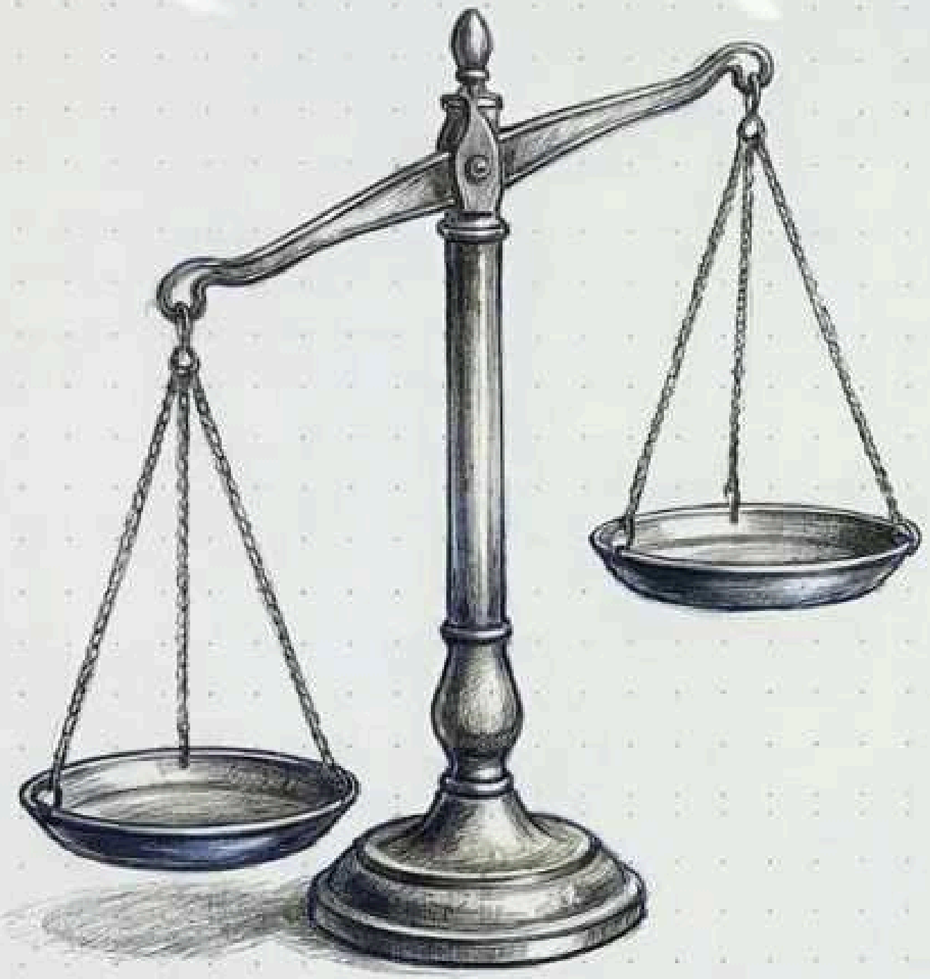
US GAAP	Global IFRS
- Highly rules-based. - Provides detailed guidance for specific situations.	- Highly principles-based. - Relies heavily on professional judgment.

Efforts to bring them closer have narrowed the differences over time.

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¶5.11

The enduring habit of prudence and conservatism



When in doubt, do not overstate assets or profits.

Inventory Value = min(Cost, Selling Price)

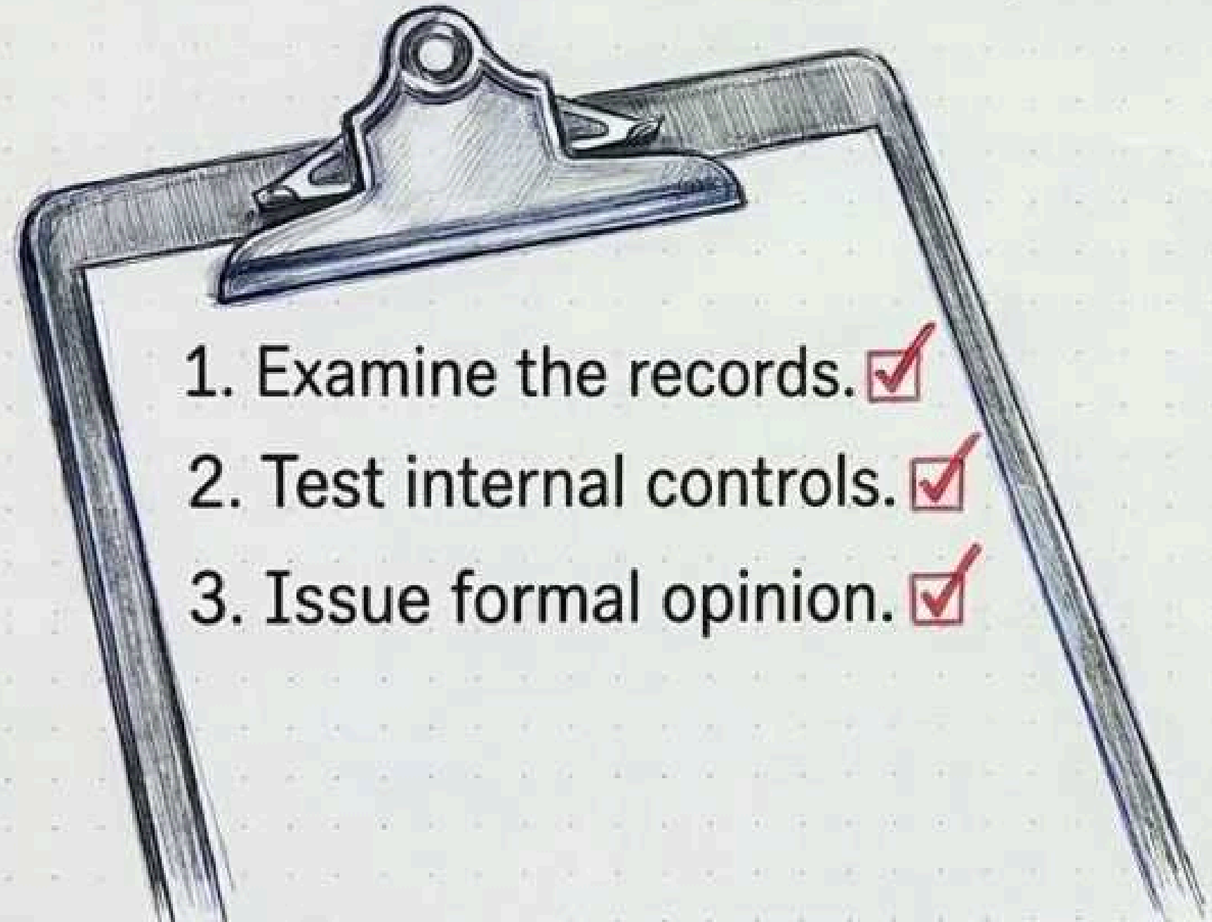
While modern standards emphasize neutrality, extreme caution regarding uncertain gains remains a deeply ingrained habit.

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¶ 5.12

Auditors ensure companies present a true and fair view

Public companies must have their accounts audited by independent accountants.



The Big Four

Deloitte	Pricewaterhouse Coopers
Ernst and Young	KPMG

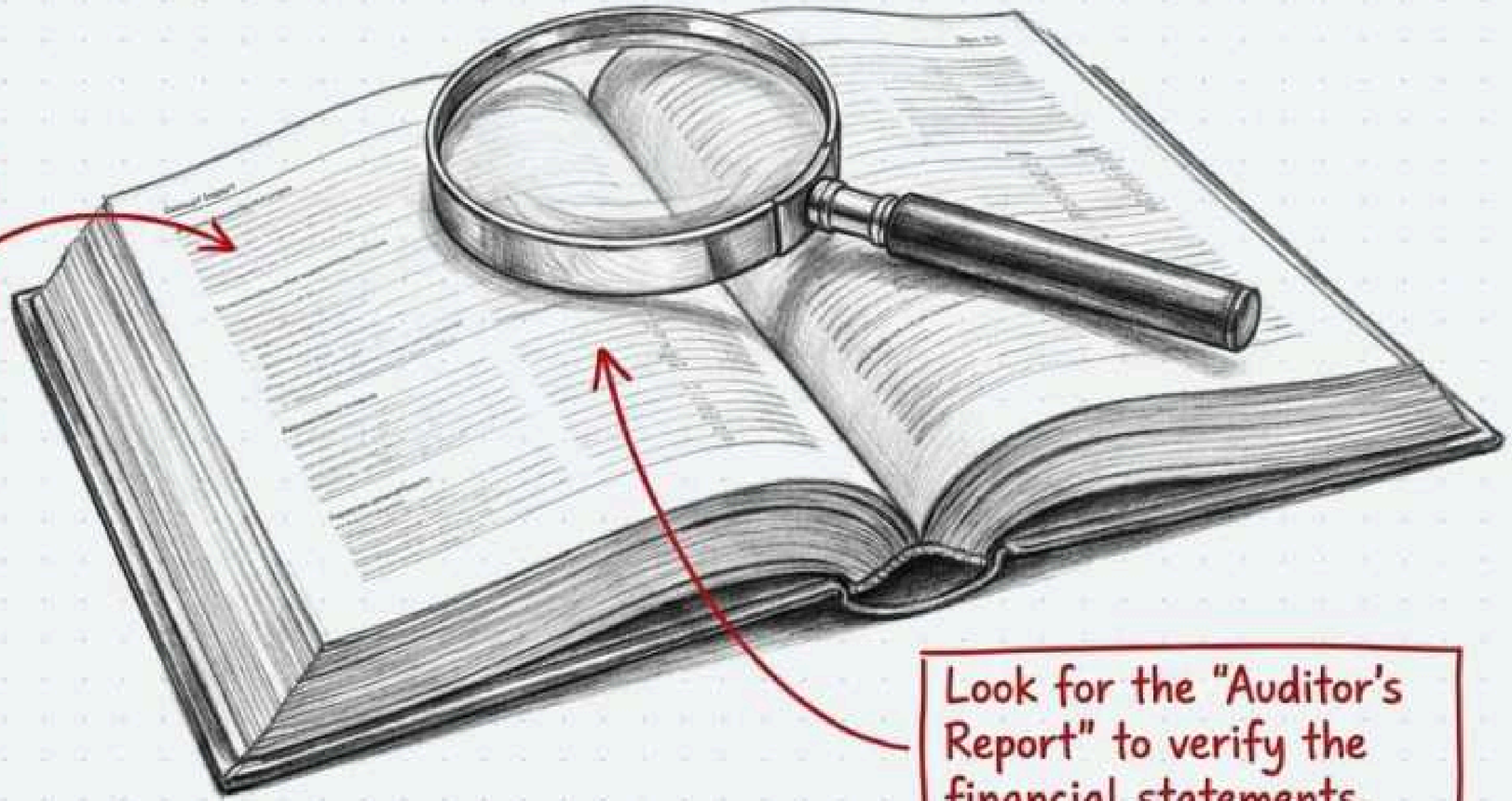
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¶ 5.13

Where to find the rules and how companies apply them

- The FASB and IFRS Foundation websites publicly explain the standard-setting process.

Look for "Significant Accounting Policies" to discover which inventory and depreciation methods the company actively uses.



Look for the "Auditor's Report" to verify the financial statements.

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Closing exercise: The impact of useful life estimates

¶5.14



A van costs $25,000.
It will be worth $5,000 at the end.

Scenario A (5-Year Life):

$$\frac{(\$25k - \$5k)}{\div 5} = \$4{,}000 \text{ depreciation per year.}$$

Scenario B (10-Year Life):

$$\frac{(\$25k - \$5k)}{\div 10} = \$2{,}000 \text{ depreciation per year.}$$

Stretching the useful life results in less depreciation, artificially creating a higher reported profit for the year!

Next up — Lecture 6: Statement Analysis & Scandals

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