

3. Alternative Inventory System

Earlier in the chapter this was stated:

“Now, there are two different techniques for recording the purchase -- depending on whether a periodic system or a perpetual system is in use. Generalizing, the periodic inventory system is easier to implement but is less robust than the “real-time” tracking available under a perpetual system. Conversely, the perpetual inventory system involves more “systemization” but is a far superior business management tool.”

The periodic system only required the recording of inventory purchases to a Purchases account; inventory records were updated only during the closing process based on the results of a physical count. No attempt is made to adjust inventory records concurrent with actual purchase and sale transactions. The weakness of the periodic system is that it provides no real-time data about the levels of inventory or gross profit data. If inventory is significant, the lack of up-to-date inventory data can be very costly. Managers need to know what is selling, and what is not selling, in order to optimize business success. That is why many successful merchants use sophisticated computer systems to implement perpetual inventory management. You have no doubt noted bar code scanners at a checkout for quickly pricing goods, but did you know that the business’s inventory records may also be updated as the item is being scanned? With a high-performance perpetual system, each purchase or sale results in an immediate update of the inventory and cost of sales data in the accounting system. The following entries are appropriate to record the purchase and subsequent resale of an inventory item:



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Entry to record purchase of inventory:

12-12-X1	Inventory		3,000	
	Accounts Payable			3,000
	<i>Purchased \$3,000 of inventory on account</i>			

Entries to record sale of inventory:

12-21-X1	Accounts Receivable		5,000	
	Sales			5,000
	<i>Sold merchandise on account</i>			
12-21-X1	Cost of Goods Sold		3,000	
	Inventory			3,000
	<i>To record the cost of merchandise sold</i>			

With the perpetual system, the Purchases account is not needed. The Inventory account and Cost of Goods Sold account are constantly being adjusted as transactions occur. Freight-in is added to the Inventory account. Discounts and returns reduce the Inventory account. Therefore, the determination of cost of goods sold is determined by reference to the account's general ledger balance, rather than needing to resort to the calculations illustrated for the periodic system.

If you think the perpetual system looks easier, don't be deceived. Consider that it is no easy task to determine the cost of each item of inventory as it is sold, and that is required for a proper application of the perpetual system. In a large retail environment, that is almost impossible without a sophisticated computer system. Nevertheless, such systems have become commonplace. This has come about with the decline in the cost of computers, along with a growth in "chain stores" that can apply the same technology to many individual stores.

One final point should be noted. A physical count of goods, where employees take to the store and count every item on hand, is still needed with a perpetual system. No matter how good the computer system, differences between the computer record and physical quantity on hand will arise. Differences are created by theft, spoilage, waste, errors, and so forth. Therefore, merchants must occasionally undertake a physical count, and adjust the Inventory accounts to reflect what is actually on hand.