INVENTORY ACCOUNTING

The flow of costs through the system and through the General Ledger can be somewhat complicated. This discussion will explain the flow plus give you suggestions on keeping the G/L and inventory detail in sync.

For your inventory, you will have two groups of accounts on your chart of accounts.

Assets
Beginning inventory balance	Beginning balance
Inventory Purchases	New purchases of inventory
Cost of Goods Sold	Shipments of inventory
Transfers In/Out	Only needed if you have multiple locations
Total of these accounts	Value of your inventory asset

P&L
Cost of Inventory Sold	Cost of inventory shipments in the current period
Physical adjustments	Cost of changes due to physical count
Junked/Expensed inventory	Cost of inventory that is damaged or used for a project
Vendor/Freight claims	Cost of inventory damaged during transit
Program Merchandise	Cost of inventory used in some special way
Total of these accounts	Cost of inventory shipped/used during the current period

You can combine several of these accounts, particularly if you have a small inventory.   For example, you may combine all of the asset accounts into a single account called "Inventory".   All of the various adjustment accounts on the P&L are frequently combined into a single account called "Inventory Adjustments".

The account numbers you want to use for these accounts are assigned on the System Options for Inventory.   You can indicate whether you want separate or combined accounts there.

As you pay for merchandise and as you sell it, journal entries are made to these accounts.   A separate file, called the inventory detail file in this discussion, contains the detail of what quantities you have on hand and what cost was used each time you received the item.

To illustrate the flow of cost, let's assume we have an inventory with only one item that costs $1.00.   An A/P invoice is entered for $1000 and posted to "Inventory Purchases".   The item is received into inventory with a quantity of 1000 and a unit cost of $1000.   At this point.

G/L Account	G/L Value	Value of inventory detail
Assets		
Inventory Purchases	$1000.00	1000 @ 1.00 = $1000.00
Cost of Goods Sold	$ .00	
Net value	$1000.00	$1000.00
P&L		
Cost of inventory Sold	$.00	
Inventory Adjustments	$.00	

Now suppose you sell 100 items.   On the Sales Journal, a journal entry will be made to reduce the value of your inventory asset and to transfer that cost to the current period's P&L.   So now you have the following:

G/L Account	G/L Value	Value of inventory detail
Assets		
Inventory Purchases	$1000.00	900 @ 1.00 = $900.00
Cost of Goods Sold	$ 100.00 -	
Net value	$ 900.00	$900.00
P&L		
Cost of inventory Sold	$100.00	
Inventory Adjustments	$.00	

Now suppose you find that one of the items is damaged and you have to throw it away. You enter an inventory adjustment to reduce the quantity on hand by one.

G/L Account	G/L Value	Value of inventory detail
Assets		
Inventory Purchases	$1000.00	899 @ 1.00 = $899.00
Cost of Goods Sold	$ 101.00 -	
Net value	$ 899.00	$899.00
P&L		
Cost of inventory Sold	$100.00	
Inventory Adjustments	$1.00	

In theory, the value of your inventory on the General Ledger should match the value of your detail. However, because of timing issues (merchandise received before A/P invoice entered, etc.), these may be hard to match up. Therefore, you should monitor the two figures (inventory value on G/L and inventory value based on inventory detail) to make sure they stay reasonably close. There is a function on the Inventory menu that lets you do this quite easily.

So what can go wrong? Several things, but these are the most common situations.

1.   The item is received at one cost but a different cost is used in A/P.

The most common example of this is where the freight is included on the A/P invoice but not the receipt. Suppose the A/P invoice is received and entered for $1025, the $1000 for the item and $25 for shipping charges.   If all of this is charged to "Inventory Purchases", then the value on the G/L side would start at $1025.

If the person receiving the order just used the cost on the order and did not add in the cost of shipping, then the value on the inventory detail would be the $1000 we used initially.

The difference between the G/L and the Inventory Detail would be $25.

Differences between the expected unit cost of the item on the purchase order and the actual cost billed by the vendor can cause similar problems as well as additional charges such as set ups, screen charges, and less than minimum charges.

Although it can go both ways, usually the symptom of this problem is that your value of inventory on the G/L exceeds your inventory detail value and that gap continues to grow.

2.   The A/P invoice is charged to the regular Purchases account in the P&L section of your Chart of Accounts.   This is the account that is used for the costs of drop shipments.

This is easy to happen if you buy both inventory and non-inventory merchandise from the same vendor.   If you use the vouching feature, the system will normally redirect the cost to Inventory Purchases if the order being vouched is an order for stock or a decoration order for stock.   However, if you don't use vouching or don't enter the order number, this is something you should watch for.

The symptom for this problem would be that the balance of inventory in the G/L is lower than your inventory detail and the gross profit for the current period is lower than expected.

3.   An A/P invoice for something other than inventory is posted to Inventory Purchases.

If you normally buy inventory from a vendor but have a drop shipment order for a large quantity, the quantity on the drop shipment might get posted to Inventory Purchases instead of regular Purchases. If you have predefined the G/L account for this vendor to Inventory Purchases, this would be really easy to miss.

Supplies may be ordered on an order for stock.   However, if you are not tracking on-hand quantities of these types of items, you should charge them to "Supplies" rather than Inventory Purchases.

The symptom for this type of problem with be the G/L balance for inventory higher than the inventory detail value.   You will see an entry in A/P with no corresponding entry in the inventory receipts for the month.

4.   A vendor's invoice for blank goods that are to be decorated and received at a later date is charged to Inventory Purchases.   Or, you pay for goods from overseas and don't receive it for several months.

This is not exactly wrong but it will temporarily inflate your G/L inventory balance.   If it all happens within the same month, this is a non-issue.

If you have a large dollar value tied up in this type of scenario and the receipt is unlikely to take place for a few months, you can post the invoice to a prepaid account and then move it to Inventory Purchases when you actually receive the merchandise.

As you can see, it is easy to get the G/L and detail out of balance.   To help you manage this issue, three reports are available under Accounts Payable under the heading "Compare A/P to inventory".

Detail of entries | This report matches all postings to Inventory Purchases and all receipts entered during a month.   Matching is by master order number. Differences are highlighted.

Tie out all orders received | This report lists all orders received during the month and all A/P entries for Inventory Purchases that have been made that month or at any other time for these orders.

This report will highlight situations where the A/P has been posted to some account other than Inventory Purchases or hasn't yet been entered. It will also highlight situations where the wrong cost was used on the receipt.

Tie out all A/P entries made | This report lists all A/P entries charged to Inventory Purchases during a period and matches that against receipts that have been entered.

This report will highlight situations where the invoice should have been charged to something else (no matching receipt) or where the receipt hasn't been entered.

The last two reports are summary reports, one line per master order.   We suggest you print those every month and look for large differences.   You can print the detail report if you need to see additional detail.

Once you find the problem, how do you correct it?

If the A/P invoice was charged to the wrong account, you will need to delete the invoice and reenter it with the correct G/L distribution.   If the invoice has already been paid, you will have to void the check, delete the invoice, then reenter the invoice with the correct information and reenter the check information.

If the item was received with the wrong cost, you should correct the cost on the receipt.   There are two receipt cost correction routines, one that looks at a single item and one that looks at the whole order. The one for the order lets you enter the total amount of the adjustment, such as the shipping charge, and will automatically spread it across all the items on the order.

As you can see, correcting the problem after the fact can be quite cumbersome.   Here are a few strategies to help you keep these types of problems from occurring or to fix them right away.

1.   **If you are not already using the "vouch against order detail" process, start using it.**

The vouching screen will usually select the correct G/L account for the distribution, although you should always verify it.   Supplies or samples ordered on an order for stock, for example, may be directed to Inventory Purchases when the expense should be posted to another account.   The system "guesses" what account to use but you must verify that it guessed right.

2.   **If you normally receive the merchandise before the vendor's invoice is entered, use the links on the vouching screen to review what has been received.**

If the order being vouched is an order for stock or an order to decorate for stock, there will be a link on the screen where you can review what has been received including the quantities and costs.

If what has been received does not match the vendor's invoice, there is another link where you can correct the received cost directly from the vouching screen.

3.   **If you normally enter the vendor's invoice before the merchandise is received, use the "receive master order" function to enter orders for stock.**

If the vendor's invoice has been entered, the vouched cost and quantity will be used as the cost on the receiving screen instead of the original values entered on the order.   Shipping costs will also be picked up from the vouched costs on the order.

Consigned goods

Consigned goods items are items that your customer pays for in full up front.   However, you keep the items in your warehouse and ship them out as requested.   Sometimes they are shipped at a zero selling price and sometimes at non-zero selling price.

In many ways these items are handled like inventory.   You receive them and can see the quantity on hand, allocated, etc.   To ship them, you enter an order to ship from inventory just as if you were shipping from your own items.   You can even mix items from your inventory and the customer's inventory on the same order.

However, because you don't own the merchandise, the accounting must be handled differently.

1.   **Because you don't own the merchandise, the value of the consigned goods inventory should not be included in your Inventory asset accounts.**

The practical side of this is that when the original order for the merchandise is entered, the order where the customer originally buys the consigned goods items, the distribution for the G/L expense on the A/P invoice should be charged to your <u>regular</u> Purchases account, not the <u>Inventory</u> Purchases account.

First of all, you don't want that cost to add to your inventory value on the G/L.

Second, you are billing the customer in the current period so you want the sales and the cost to be included on the G/L in the same month.   So the cost needs to go to a P&L account such as Purchases.

2.   Because the consigned goods items are not included in your inventory and have already been taken care of for G/L purposes, there should be no updates to either your inventory value or your P&L expense when these are shipped.

Lakeshore does not include consigned goods items in the inventory-related portion of the journal entry made from the Sales Journal.   The same is true of various inventory adjustments.

3.   If you ship the merchandise out at a non-zero sales, these "sales" should go to a liability account since you are basically collecting this money for the customer.

This account is usually called "Consigned Goods Sales" or "Due to Clients" and would be in the liability area of your Chart of Accounts.

If you ship out the consigned goods at a non-zero price, the "sales" from these would go to this account rather than the "Sales" account normally used for drop ship merchandise or for inventory you own.

If you rebate this money to the customer who owns the merchandise, you would use this account in the G/L distribution of the A/P invoice when you generate the customer's check.

If you use the money to buy additional inventory for the program, then you would use this account in the G/L distribution of the A/P invoice where you pay for the new merchandise.

Here is some other general information about consigned goods:

♦   Sometimes your customer wants to sell their merchandise to an end user such as a store or employee at a marked up price.   The system will handle the accounting properly as noted above. There are, however, specific ways you need to set up the item.   Use the price the customer originally paid for the merchandise as the "current cost".   Note that this is the customer's cost, not yours.   Then, put the price the customer wants to charge the end user in the selling price.

For reporting purposes, you can use the Invoice Inventory Activity report to report to the customer what was sold during the reporting period as well as his profit on the items sold.

♦   If you print a report like the Invoice List and try to compare the total sales on the report to the sales reported on the G/L, be sure to also include the sales in the "Due to Customer" account if you ship any consigned goods items out at a non-zero selling price.

♦   The sale of the consigned goods items as far as you are concerned takes place when you bill the customer originally.   This is when the data is posted to sales history.   Shipments of consigned goods items are **not** posted to sales history because they are not your sales.   Be sure to allow for that when comparing sales history data to the G/L.