

THEME: COST OF GOODS SOLD

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ACCOUNTING TERM: Cost of Goods Sold

The definition of “Cost of Goods Sold” is the *cost* of goods that have been removed from inventory and delivered to customers (sold) during an accounting period.

FEATURE ARTICLE: Recording Cost of Goods Sold

If you are in the business of selling T-shirts and you pay \$10 for each one and then sell the T-shirt for \$11.00, there is a good chance that you won't be in business much longer. Your margin of profit is pretty darned skinny. Yet, it might amaze you to find out how many businesses end up doing just this. It happens for a couple of reasons: The first is that lowering prices is a way to attract new business to your store and beat the competition; the second is that there is an illusion of making money because high volume sales (customers know a good deal when they see one) generates cash flow. However, the business may simply be “robbing Peter to pay Paul” and reality has not yet caught up with the illusion. This problem is exacerbated when there are no timely financial statements prepared which would reveal the truth of the situation.

Determining the cost of goods that are sold is an important and critical process that must be performed for a business to measure its profitability. Sometimes this process can be confusing for newcomers even though the concepts are fairly straightforward.

To understand how Inventory transactions are recorded, I think it is best to first paint a picture of what is going on. For instance, you have a T-shirt store. You buy 100 T-shirts from a wholesaler at \$10.00 each, mark them up and sell them. Before you sell the T-shirts, they are recorded as an asset on your Balance Sheet in an account called T-shirt Inventory. Sometimes you pay cash for the T-shirts and sometimes you use your good credit to buy them. The journal entry might look like this:

DESCRIPTION	DEBIT	CREDIT
T-shirt Inventory	1,000.00	
Cash		200.00
Accounts Payable		800.00

If you have forgotten how debits and credits work, follow this link for a reminder:

http://www.reallifeaccounting.com/accounting_model.asp

Let's say you sold 50 T-shirts for \$15.00 each resulting in total cash sales of \$750.00. The journal entry for the sales transaction is:

DESCRIPTION	DEBIT	CREDIT
Cash	750.00	
T-shirt Sales		750.00

There are still two things left to do:

- 1) You have to determine what your Gross Profit is from the sale.
- 2) You have to adjust the T-shirt Inventory account to reflect the actual number of T-shirts remaining in stock.

To do this, you must figure out what your Cost of Goods Sold is. This will be easy to figure out using our simplistic example. You paid \$1,000.00 for 100 T-shirts so each one cost \$10.00. Since you sold 50 T-shirts your Cost of Goods Sold is \$500.00 (50 x \$10.00). Often it is not that easy to figure Cost of Goods Sold, so instead, the business owner can use a "deduction" method to arrive at the figure.

Let's say you have a beginning T-shirt Inventory balance of \$300.00. Following our example above, you purchased an additional 100 T-shirts for \$1,000.00. At this point, you theoretically have \$1,300.00 worth of T-shirts in stock. However, you sold 50 of them to customers. The next step is to take a physical count of how many T-shirts are left. There are 80 unsold T-shirts still on your shelves (Thirty to start plus 50 remaining). Each one cost \$10.00, therefore you have \$800.00 in T-shirt Inventory at the end of your accounting period. Look at the Inventory formula:

Beginning T-shirt inventory	\$ 300.00
Add purchases during the month	1000.00
Subtract ending T-shirt inventory	<u><800.00></u>
Cost of Goods (T-shirts) Sold	\$ 500.00

A journal entry must be written to remove the T-shirt inventory that has been sold from the asset account T-shirt Inventory and record the amount as an expense that directly offsets the recorded sales of the T-shirts.

DESCRIPTION	DEBIT	CREDIT
Cost of Goods Sold	500.00	
T-shirt Inventory		500.00

The transactions would appear on your Profit & Loss Statement like this:

T-shirt Sales	\$750.00
Less Cost of Goods Sold	<u><500.00></u>
Gross Profit	\$250.00

In case you don't know, Gross Profit is: Revenue minus Direct Costs equals Gross Profit. Gross Profit minus Indirect Costs equals Net Profit. Direct Costs are those costs that can be directly attributed to the production of Revenue, such as Purchases (another name for Cost of Goods Sold), Freight, Contract Labor, Production Supplies, etc. Indirect costs are your operating overhead costs such as Accounting, Bank Charges, Office Expense, Utilities, etc.

How Cost of Goods Sold is measured depends on the type of business you have. The example I used above is the method a retail operation might use. A manufacturing business would go about it in a different manner. Regardless what type of business, the central issue is to match the cost of goods, purchased or manufactured, against those same items that were sold in order to determine how much profit was generated during the accounting period.

QUESTION: How Often Must I Take A Physical Inventory Count?

Some business owners take a physical count monthly, some daily if they have to, but many do it once a year, like on December 31st, or January 1st. How can a retail store maintain an accurate Cost of Goods Sold during the year if the inventory is only counted once a year? Since taking a physical inventory in many retail stores is a big project, storeowners use a method known as the "retail method". If a storeowner knows how much his/her goods sold are "marked up" from their original cost, then it is possible to estimate the cost of goods sold for the accounting period, such as one month.

Using the example of the T-shirt store, if the owner had \$750.00 in sales and on average had marked up goods sold by 50% or, a factor of 1.50, then all that is required is to divide the \$750 in sales by the mark-up factor of 1.50 to arrive at cost of goods sold \$500.00.

$$\$750.00 \text{ divided by } 1.50 = \$500.00$$

To verify this, take the cost of inventory \$500.00 times 50% to get the result of \$250.00. Add the marked up amount of \$250.00 to the inventory cost of \$500.00 to arrive at the sales price of \$750.00.

The following journal entry is then written:

DESCRIPTION	DEBIT	CREDIT
Cost of Goods Sold	500.00	
Inventory		500.00

Using the “retail method” the owner will at least be in the ballpark as to the true cost of goods sold and gross profit. At the end of the year when the owner takes an actual physical inventory he/she simply compares the actual inventory to the book inventory, adjusts for the increase or decrease using a journal entry and at year-end has an accurate reflection of both Inventory and Gross Profit.

How often a physical inventory should be taken is determined by the type of business, the level of accuracy desired in the financial statements, availability of personnel to conduct the physical count, and other factors that may be unique to the business.

TIP: Differentiate Between Cost of Goods Sold Percentage and Mark-up Percentage.

Knowing the difference between Cost of Goods Sold percentage and mark-up percentage can be tricky to understand. Yet, knowing this difference can prevent your Gross Profit from becoming distorted. The erroneous thought process goes something like this: My sales are \$15.00 and my inventory mark-up is 50% so to get my Cost of Goods Sold I'll simply multiply 50% x \$15.00. This tells me that my Cost of Goods Sold is \$7.50, therefore my Gross Profit is \$7.50 (\$15.00 minus \$7.50 = \$7.50). This is flat out wrong and here's why:

If your mark-up percentage is 50% on a good you purchased for \$10.00, then obviously the sale price of the good is \$15.00. With a sale price of \$15.00 per item and a cost of each inventory item at \$10.00, the Cost of Goods Sold percentage is 67%. Divide \$10.00 by \$15.00 to arrive at 67%.

The confusion arises when you try to multiply your **mark-up percentage** of 50% to Gross Sales \$15.00 (50% x \$15.00 = \$7.50), instead of your **Cost of Goods Sold Percentage** of 67% (67% x \$15.00 = \$10.00). Marking up gross sales rather than inventory does not make sense. It seems simple and obvious when you read it here, but it is a common mistake that business owners can make if they haven't fully thought out the process.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at <http://www.reallifeaccounting.com> to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.

