Inventory, cost of goods sold

Business

1. Introduction

This paper seeks to write about the relationship of inventory and cost of goods sold and how information on matter for decision-making in business. The paper will discuss the importance of the information from two accounts in computing the needed financial ratios of the company that would help the company know its profitability and liquidity which will lead to better decision for companies.

2. Analysis and Discussion

2. 1 Inventory and Cost of Goods Sold

Inventory is an accounting account that represents goods for sale in business. It is therefore basically considered an asset account that can be found in the balance sheet. However in addition, the same account appears also in the income statement either as beginning inventory or ending inventory. The balance sheet and the income statement are the two basic financial statements that are used by accountants to summarize the financial position and results of operation of business entity respectively for given periods. In the balance sheet can finds the assets, liabilities and capital while in the income statement one finds the revenues and expenses. An example of income statement and balance sheet is provided in Appendices A and B.

Since the inventory accounts may appear in the income statement as beginning or beginning inventory, there is need to make classify beginning inventory as part of the expense accounts and ending inventory as part of the revenue accounts for purposes of computing the profits of the business

since the basic formula to compute the same is to deduct expenses from cost. In so classifying the beginning inventory and ending inventory as expense and revenue account respectively, the cost of goods sold is necessarily produced in the case of income statement of a trading concern after considering further purchases and freight in as part of the cost goods available for sale and purchases discounts and purchase returns and allowance as part of the reduction of purchases. It can therefore be safely asserted that that inventory and cost of goods sold are material information in computing the gross profit of the business before operating expenses could be further deducted to arrive at operating income.

At the same time, since the ending inventory will appear as part of the current assets of the business for a given period, the same must be considered necessary in computing the current assets and total assets of the business.

2. 2 How each account is used in for decision making?

As explained earlier understanding the nature of inventory and cost of goods sold requires relating them to the bigger picture or in the financial statements where the two are made part. Without the required information on the inventory, the income statements would be either overstated or understated. Since the inventory accounting could either appear as beginning inventory or ending inventory, then it could affect the expense account and revenue account of the income statements. Any errors therefore could result to misstatement of the income statement. Since the same ending inventory is also part of the assets portion of the balance sheet particularly under the current asset section of the balance sheet, any

material misstatement could affect the proper amount of asset that would be reported.

Moreover, since inventory is part of the revenue account of the income statement which is material in the computation of the cost of goods sold, correct information on the two items lead to knowledge of more accurate profitability which may expressed in financial ratios of gross profit margin, operating margin and net profit margin. These ratios would further reveal the efficiency of doing business since under the mentioned formulas relating to margins, gross profit, operating profit and net profit taken separately are divided by the same total revenues of the business. Since the same ending inventory is also part of the current assets and total assets, the presence of the correct information will also lead to better or more accurate information of profitability ratios of return on assets and return on equity. This will also lead to the determination of the liquidity ratios which is accomplished by dividing current assets to current liabilities. While profitability ratios (Helfert, 1994) tells the company whether the company should continue or improve its operating performance, liquidity ratios (Meigs, Meigs and Meigs, 1995) will put the company on guard on meeting its necessary obligation to creditors in a timely manner. An example to the ratios is provided in Appendix C.

3. Conclusion

It can be concluded that inventory and cost of goods sold are very important part of the financial statements and their importance could best appreciated if assumed that are not available or not properly reflected. If material misstatements could happen in the financial statements, the effects would

possible an adverse opinion by external auditors who are to make an opinion on the reliability of thefinancial statementrepresentation by the management which are required by law to file financial statements to the United States Securities and Exchange Commission. If financial statements are not correct, they will lose the very essence of their purpose and the investing public and other stakeholders would necessarily be deprived by what they need to know before they will have to make their investments in the stock of corporations.

4. Appendices

Appendix A – Sample income statement; Source YahooFinance(2009a)

Appendix B- Sample balance sheet; Source Yahoo Finance (2009b)

Appendix C- Sample financial ratios; Source Yahoo Finance (2009c)

References:

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