21. Inventory Errors

In the process of maintaining inventory records and the physical count of goods on hand, errors may occur. It is quite easy to overlook goods on hand, count goods twice, or simply make mathematical mistakes. Therefore, it is vital that accountants and business owners fully understand the effects of inventory errors and grasp the need to be careful to get these numbers as correct as possible.

A general rule is that overstatements of ending inventory cause overstatements of income, while understatements of ending inventory cause understatements of income. For instance, compare the following correct and incorrect scenario -- where the only difference is an overstatement of ending inventory by $1,000 (note that purchases were correctly recorded -- if they had not, the general rule of thumb would not hold):

	Correct		Incorrect
Beginning inventory	$ 5,000		$ 5,000
Purchases	11,000		11,000
Cost of goods available for sale	$16,000		$16,000
Ending inventory	4,000	Overstated	5,000
Cost of goods sold	$12,000		$11,000
Sales	$25,000		$25,000
Cost of goods sold	12,000		11,000
Gross profit	$13,000	Overstated	$14,000

Had the above inventory error been an understatement ($3,000 instead of the correct $4,000), then the ripple effect would have caused an understatement of income by $1,000. Inventory errors tend to be counterbalancing. That is, one year's ending inventory error becomes the next year's beginning inventory error. The general rule of thumb is that overstatements of beginning inventory cause that year's income to be understated, while understatements of beginning inventory cause overstatements of income. Examine the following table where the only error relates to beginning inventory balances:

	Correct		Incorrect
Beginning inventory	$ 4,000	Overstated	$ 5,000
Purchases	11,000		11,000
Cost of goods available for sale	$15,000		$16,000
Ending inventory	3,000		3,000
Cost of goods sold	$12,000		$13,000
Sales	$25,000		$25,000
Cost of goods sold	12,000		13,000
Gross profit	$13,000	Overstated	$12,000

Hence, if the above data related to two consecutive years, the total income would be correct ($13,000 + $13,000 = $14,000 + $12,000). However, the amount for each year is critically flawed.