

20.2 Exercises to consider some problems in accounting for stock

1.

Explain why it is easier to mis-state the value of closing stock in a set of accounts, than it is to mis-state the value of sales or purchases.

Response

Figures for sales and purchases in a set accounts are derived from the recording of transactions. Thus any arbitrary mis-statement of sales will throw the accounts out of balance, unless there is a compensating adjustment somewhere else in the accounts – thus if we wish to report a higher figure for sales, we must also report a higher figure for cash or for debtors. Likewise any arbitrary mis-statement of purchases will also throw the accounts out of balance unless there is a compensating adjustment in some other account(s), such as creditors or cash.

The figure for stock, however, does not arise from a transaction. The value involved is merely transferred from one account to another, and as long as the same figure used for both sides of the transfer, the accounts will remain in balance, no matter how mendacious the figure may be.

2 (a)

A firm sells a single line of stock, which it buys at constant prices. Purchases are recorded immediately in a Stock Account, and when goods are sold, their cost is transferred out of the Stock Account and into a Cost of Sales Account. In this way, the firm's Stock Account will always show an up-to-date cost of stock currently in the business.

a) Explain how this system would work, using entries on a set of T accounts.

Response

Imagine two transactions:

1. the firm buys 100 units at £1 each
2. the firm sells 20 units for £1.50 each (sale of 20 units @ £1.50 each = £30).

The purchase in transaction 1 will be recorded like this:

<i>Stock</i>		<i>Money or Promises</i>	
(1)	100	(1)	100

The sale in transaction 2 will be recorded like this:

<i>Money or Promises</i>		<i>Sales</i>	
(2)	30	(2)	30

So far this is very little different from the standard procedure. However, in this system, **at the same time as recording transaction 2**, the firm will **also** transfer the cost of the goods sold (in this case, cost of 20 units @ £1 each = £20) OUT of the Stock Account and IN to a Cost of Sales Account, like this:

<i>Stock</i>		<i>Cost of Sales</i>	
(1)	100	from Stock	20
		to Cost of Sales	20

The balance on the Stock Account should now always show the cost of goods held in stock at any time, while the balance on the Cost of Sales Account can be transferred to the P&L Account at the end of the period to determine profit.

2 (b)

A firm sells a single line of stock, which it buys at constant prices. Purchases are recorded immediately in a Stock Account, and when goods are sold, their cost is transferred out of the Stock Account and into a Cost of Sales Account. In this way, the firm's Stock Account will always show an up-to-date cost of stock currently in the business.

b) This system involves no account for purchases. How would you be able to use information from the accounts to determine the value of purchases in a period?

Response

Normally, we must start with the figure for purchases and adjust it to find the cost of goods sold by

- adding the cost of any goods in stock at the start of the period, and
- taking out the cost of any goods held in stock at the end of the period.

In this system, we start with the figure for Cost of Sales, given in the accounts, and adjust it to find the cost of purchases in the period by

- adding the cost of any goods purchased in the period but not yet sold (closing stock), and
- taking out the cost of any goods that were not purchased in the period because they were already present in opening stock.

2 (c)

A firm sells a single line of stock, which it buys at constant prices. Purchases are recorded immediately in a Stock Account, and when goods are sold, their cost is transferred out of the Stock Account and into a Cost of Sales Account. In this way, the firm's Stock Account will always show an up-to-date cost of stock currently in the business.

c) Why do you think that this, or a similar system of accounting for stock, is not more widely used?

Response

This system will only work if the cost of the goods sold is known *at the time of every sale*. Where, as in our description, the firm buys goods for resale at constant prices, this requirement is easily met (because all goods of the same kind will have been acquired at the same cost). But when purchase prices for identical goods vary throughout a period, as they do in real life, in most cases it would involve an unacceptable level of effort to attach a different cost to each individual unit of stock.