Answer to a question from a student: how does change in inventory affect computation of cash payments for inventory in the month?

Answer

Please do not get confused when talking about cost of sales and cash paid for purchases. They are different.

You may buy more or less inventory than you sell.

Also a decrease in inventory does not necessarily affect cost of sales.

Cost of sales is the cost of what you sold, which may not be equal to the cost of the inventory you bought.

First, you buy inventory. Then you pay for the inventory. How much you buy and how quickly you pay affect your total disbursements for the period – these actions do not affect cost of sales.

It is possible to begin the period with no accounts payable and then simply sell from your existing inventory, without buying more inventory. You will have a cost of sales, but you will not pay anything for inventory this month – if you don’t buy any inventory.

**Let me illustrate with an example. (Sell 300 hats, but replace only 200 hats)**

You have a clothing store. You buy hats at a wholesale cost of $10.

Your clothing store begins April with a zero balance in accounts payable for inventory.

You have 500 hats in inventory at the beginning of April.

You sell 300 hats to your customers in April.

You buy 200 hats from your supplier in April.

Your cost of sales is $3,000 (300 hats at $10) for April

But you did not pay $3,000 for hats in April.

You only bought 200 hats at a cost of $2,000.

If you paid for the 200 hats, we would also say that you spent $2,000 even though cost of sales was $3,000.

You saved cash of $1,000 in April by buying 100 fewer hats than you sold in April.

Reducing inventory allowed you to spend less to replace some of the inventory that was sold.

So if you are adjusting your cost of sales to get cash disbursements, you add the amount you did not pay to replace sold items (the amount of the reduction in your inventory).

**Example. (Sell 300 hats, but buy 400 hats, resulting in an increase in inventory)**

If you had decided to buy 400 hats in April, your cost of purchases would be $4,000 (which is more than cost of sales of $3,000).

Your ending inventory would be 600 hats, which is 100 more than beginning inventory.

Assume you bought 400 hats on credit (accounts payable) in April.

How much did you pay for those hats in April?

That depends on how much you paid on your accounts payable in April.

If you paid nothing in April, you will owe accounts payable of $4,000 at the end of April.

If you paid $3,000 on accounts payable, you will owe $1,000 on accounts payable at the end of April.

The increase of $1,000 in accounts payable, means you saved cash of $1,000 by paying for fewer hats than you bought. However you will have to pay later.

You start with the amount of purchases --and compute amount paid for purchases by adjusting for the beginning balance and the ending balance in accounts payable. If the ending balance of accounts payable is the same as the beginning balance in accounts payable, we say your payments were equal to your purchases.

If the ending balance of accounts payable is more than the beginning balance in accounts payable, we say your payments were less than your purchases. You are paying for less than you are buying and you are building up a larger accounts payable balance.

Howard