![AccountMate - SOFTWARE THAT FITS]

Article # 1137

Technical Note: Understanding How AccountMate Reverses the Costs of Cancelled PO Receipts involving Average Cost Items

Difficulty Level: Advanced Level AccountMate User

Version(s) Affected: AccountMate 7 for SQL and Express
AccountMate 7 for LAN
AccountMate 6.5 for SQL and MSDE
AccountMate 6.5 for LAN

Module(s) Affected: Purchase Order, Inventory Control, General Ledger

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DESCRIPTION

From time to time, users may need to cancel some PO receipts that they have recorded. It may be that they have to return the items received because the wrong items were shipped to them or the items were of substandard quality. Regardless of the reasons for canceling a PO receipt, such a transaction will always require a reversal of cost which in turn will affect the total cost and, in some cases, the unit cost of the remaining units of your inventory.

This Technical Note is provided to discuss the approach that AccountMate takes with respect to the cost that is used to cancel a PO receipt involving average cost items, and explain the principles behind it. It will also discuss the GL entries that will be generated. Finally, it will illustrate how the total cost and unit cost of the remaining units are affected by the cancellation of the PO receipt.

SOLUTION

A. AccountMate's Approach to Reversing PO Receipts

Currently, AccountMate handles the reversal of PO receipts in two phases:

1. It reverses the original PO receipt transaction using the original PO receipt unit cost.
2. It records an adjustment to bring the average unit cost back to what it was immediately before the cancellation of the PO receipt.

To illustrate this, consider the following transactions:

06/01/09 - Received 5 units @ $38/unit
06/04/09 - Received 4 units @ $36/unit
06/11/09 - Sold 8 units using an average unit cost of $37.11
06/12/09 - Returned 1 defective unit from the set received on 06/01/09

Date	Transaction Type	Qty*	Unit Cost	Transaction Amount*	Running Balance	Ave. Unit Cost
06/01/09	PO Receipt 1	5	$38.00	$190.00	$190.00	$38.00
06/04/09	PO Receipt 2	4	$36.00	$144.00	$334.00	$37.11
06/11/09	Sale	-8	$37.11	-$296.88	$37.12	$37.12
06/12/09	Cancel PO Receipt 1	-1	$38.00	-$38.00	-$0.88	-$0.88
06/12/09	System Adjustment	0	N/A	0.88	$0	$0
Balance		0			$0	$0

Note: The negative sign in the Qty and Transaction Amount columns denotes a reduction to the total quantity and total cost, respectively.

As you can see from the table, the return of a defective unit from the set received on 06/01/09 was recorded with a unit cost of $38 – the unit cost at which the item was originally received. However, this causes the inventory record to have a negative cost balance even if there are no units of the item left. To resolve this discrepancy, a system-initiated cost adjustment is recorded.

The amount of the system-initiated cost adjustment is calculated using the following formula:

CADJ = (Returned Qty x Original Unit Cost) - (Returned Qty X Prevailing Average Unit Cost)

Where:

CADJ = system-initiated cost adjustment
Original Unit Cost = the unit cost of the item from the PO receipt record
Prevailing Average Unit Cost = the average unit cost immediately before the PO receipt was cancelled

AccountMate uses this process each time a PO receipt is cancelled, regardless of whether the said transaction results in a zero on-hand quantity for the item.

B. Rationale for the Approach

When a PO receipt is cancelled, two concerns must be carefully addressed:

1. The accounting entries for the PO receipt must be reversed to the full extent of the original cost of the units returned.
2. The chosen inventory valuation/cost method must be consistently applied in compliance with Generally Accepted Accounting Principle (GAAP).

When a PO is received and a liability for it is accrued, such liability must be reversed when the receipt is cancelled. It makes no sense to have a liability amount outstanding when the transaction that gave rise to it was cancelled.

Meanwhile, GAAP requires that issuances of inventory be recorded using a consistent valuation/costing method, whatever that method may be. While the cancellation of a PO receipt does not fall under the conventional definition of an inventory issuance, it must still be recorded using the prevailing unit cost to ensure the consistent implementation of the selected inventory cost method. As was shown in our previous illustration, it is all too possible that using a unit cost other than the prevailing average unit cost for canceling a PO receipt will result in a negative on-hand cost even though there are no more units of the item remaining. In some situations it may be a positive on-hand cost instead of a negative on-hand cost; in any case, neither condition is desirable. To avoid such conditions, and to ensure that the cost method is applied consistently for all transactions that give rise to a reduction in inventory, an adjustment is made to bring the inventory balance back to what it would have been had the cancellation of the PO receipt been recorded using the prevailing average unit cost.

These are the reasons for the two-phased approach used when reversing costs for cancelled PO receipts.

C. GL Accounting Entries

Continuing on with our illustration, AccountMate generates the following GL entries for the cancellation of the PO receipt:

06/12/09 DR: Accrued Received Goods (@ original cost) $38.00
06/12/09 CR: Inventory (@original cost) $38.00
        This entry will reverse the original accrual for PO received goods.

06/12/09 DR: Inventory (38.00-37.12) $0.88
06/12/09 CR: Cost Adjustment $0.88
        This entry will adjust the inventory unit cost back to the average cost prevailing immediately before the PO receipt was cancelled.

All system-initiated cost adjustments are listed in the **Inventory Adjustment Report**. These are easily identifiable as they use the Remark "Cost Variance Adjustment" and have a zero Adjustment Qty, zero Unit Cost and either a positive or negative Adjustment Value.

D. Effects that Canceling a PO Receipt has on the Total Cost and Unit Cost of

the Remaining Units of the Item

To illustrate the effect that canceling a PO receipt has on the total cost and unit cost of the remaining units of inventory, let us use the following example:

06/01/09 - Received 6 units @ $38/unit
06/04/09 - Received 6 units @ $36/unit
06/11/09 - Sold 8 units using an average unit cost of $37
06/12/09 - Returned 1 defective unit from the set received on 06/01/09

Date	Transaction Type	Qty*	Unit Cost	Transaction Amount*	Running Balance	Ave. Unit Cost
06/01/09	PO Receipt 1	6	$38.00	$228.00	$228.00	$38.00
06/04/09	PO Receipt 2	6	$36.00	$216.00	$444.00	$37.00
06/11/09	Sale	-8	$37.00	-$296.88	$148.00	$37.00
06/12/09	Cancel PO Receipt 1	-1	$38.00	-$38.00	$110.00	$36.67
06/12/09	System Adjustment	0	N/A	1.00	$111.00	$37.00
Balance		**3**			**$111.00**	**$37.00**

Note: The negative sign in the Qty and Transaction Amount columns denotes a reduction to the total quantity and total cost, respectively.

In this example, the cost adjustment is the difference between the original unit cost at which the PO was received ($38/unit) and the average unit cost at the time the PO receipt ($37/unit) was cancelled. Since the original unit cost is greater than the prevailing average unit cost, the adjustment is a positive entry to add back the difference.

Once the cost adjustment is recorded, the average unit cost of the remaining items is brought back to the unit cost prevailing before the cancellation of the PO receipt. The total cost (i.e. Running Balance) is also adjusted.

Understanding how AccountMate reverses the costs of cancelled PO receipts involving average cost items will help you to more effectively verify changes to the average cost item's unit cost and total cost. This takes you one step closer to a fair and accurate presentation of the company's total inventory item cost in your financial statements.

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