Cost-of-Sales vs. Opening/Closing Stock

Attention

Tip

Hot Tip

Warning!

Smarties ❶❷❸❹❺❻❼❽❾❗

Bright Sparks ◆1 ◆2 ◆3 ◆4 ◆5 ◆6 ◆7 ◆8 ◆9

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1. <u>What is Cost-of-Sales</u>

Simply put, Cost-of-Sales is that part of any sale that determines the direct amount that it costs the business to do a sale. According to popular opinion, a more accurate description of the Cost-of-Sales would be to refer to it as "Cost of the Goods Sold". It is important to determine Cost-of-Sales on any sale, because it is used to calculate the Profit (Gross Profit or Margin on the sale).

Another way to describe Cost-of-Sales would be to refer to it as the amount of money that it will cost you to replace the goods that had been sold (assuming the pricing from your supplier has not changed).

Cost-of-Sales is important in order to calculate Gross Profit for a particular sale; you have to know what it cost you to do the sale. Everything that had been a direct cost to the sale can be seen as Cost-of-Sales. (This however should not be confused with overhead cost. Overheads are deemed indirect costs to sale and is used to determine Nett-Profit).

To work out Gross Profit (GP or Margin), you simply take the sale and then deduct the amount that the goods that was sold actually cost – the Cost attached to the sale or "Cost-of-Sales". The resulting figure would then be referred to as **Gross Profit**. Gross Profit is also known as Profit before overhead expenses. A good example is a can of Soda that is sold in a Shop. The selling price is R 10.00. It Cost the owner is R 6.00 when he bought the soda at the wholesalers. The R 6.00 is then the Cost-of-Sales. Now, Selling price less the Cost-of-sales = Gross Profit.

$$\begin{array}{l} \quad\ \ \text{R 10.00}\ \ \text{(Sales)} \\ -\ \text{R}\quad \text{6.00}\ \ \text{(Cost-of-Sales)} \\ \hline = \text{R}\quad \text{4.00}\ \ \text{(Gross Profit – Also known as } \textbf{\textit{Margin or GP}}) \end{array}$$

This should not be confused with Nett Profit. Nett Profit is calculated by adding up all the overhead expenses such as Rent (R1.00), Salaries (R1.00), Tax (R1.00) and so on, and then to deduct that from the Gross Profit. The resulting figure will then be known as **Nett Profit**.

Traditionally, Cost-of-Sales was always worked out manually. In modern times tough, you may choose between a manual and an automated approach to Cost-of-Sales. Revelation accounting Software caters for both.

2. <u>Why is Cost of Sales not always turned on in Revelation</u>

First of all, we would like to explain why cost-of-sales is not switched on in so many Revelation users' packages. It is actually very simple. Revelation is the very first accounting package to run on a pc in South African (and many countries in the western world). When pc based accounting was introduced, auditors were not familiar with the concept of automating the cost-of-sales process. This was largely due to the fact that most auditors of the day, still kept a manual set of books as pc's were not trusted till much later.

Being the leader in PC accounting, Revelation took a conservative stance, and left the calculations up to the auditors to rather post journals to calculate stock and cost-of-sales (not a recognized term at the time) as we did not want to alienate the auditing fraternity. Up to this point (Revelation Plus) we kept the stock ledger separate from the rest of the ledgers. It was only with the introduction of Revelation Pro, that stock was integrated. It was also at this

point that auditors recognized the benefit of computerized accounting on a wider scale (as well as started to really trust PC-based systems).

Revelation was also the first company that allowed package upgrades that allowed you to import the entire ledger system into our subsequent updates (A practice that continued to this day). The reason was obvious, we did not want users to loose information when upgrading. Unfortunately, the downside to this process is that bad setup's and habits were also transferred. Revelation incorrectly assumed that Auditors and bookkeepers would automatically switch on improvements like Cost-of-Sales. Sadly, this did not always happen. Many Revelation users still use the Opening and Closing stock method to calculate stock.

New up and coming auditors and bookkeepers do not realize that this option can simply be switched on with a click of a button and two simple journals. They then recommend to users to rather migrate to opposition products.

WE THEREFORE HIGHLY RECOMMEND THAT YOU CHECK IF COST-OF-SALES IS SWITCHED ON. IF NOT PLEASE INVESTIGATE THE OPTION TO ENABLE THIS FEATURE.

To see if Cost-of-Sales is switched on in your Revelation Package, click on the [SETUP] option under the dropdown menu.
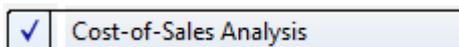
If there is a tick next to the Cost-of-Sales Analysis, this option is currently ENABLED. If not, you may have a problem.
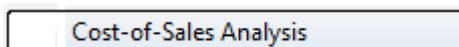
Before we can explain which option is best, you will have to have a good understanding of how both options calculate the Cost of the goods that was sold.

3. How does Opening & Closing Stock method work (Manual System)

To calculate the Cost-of-sales using the manual method, a calculation and manual Journals must be done on a regular basis. To work out the value of the Cost-of-Sales, the following formula will apply - Cost-of-Sales = Opening Stock value (Stock-on-hand at Cost) Plus the Purchases (of Stock at Cost) Less the Closing Stock Value (Stock-on-hand At Cost).

　　　C.O.S. = Opening Stock + Purchases – Closing Stock

In our Example, we had ten tins of soda in stock at a cost price of R 6.00 before we started trading. The Total Value of the Opening Stock was then R 60.00. We then bought another ten soda's at R 6.00 cost price each. Thus the purchases were R 60.00. We now look at the amount of stock that is left over at the end of the month. In this case it is five tins of soda at cost price R 6.00

Opening Stock	R 60.00
Purchases	R 60.00
Closing Stock	-R 30.00
C.O.S.	R 90.00

3.1. <u>Advantages of the Manual System</u>

The obvious advantages to the manual system are:

a) The Purchases of the company can easily be identified on the Trial Balance. It is then fairly easy to monitor the total purchases versus the total sales.

b) No stock adjustments have to be done on the Trial Balance for missing stock as all lost stock will automatically be worked into the Cost-of-Sales. (Unless a Journal for missing stock is passed before the calculation is done. The formula should then look like this.

Cost-of-Sales = Opening Stock + Purchases - Stock Losses – Closing Stock

The same is then true for Stock that was recovered. The formula is then calculated as such.

Cost-of-Sales = Opening Stock + Purchases + Stock Recovered – Closing Stock

3.2. <u>The Disadvantages of the Manual System</u>

When working with the manual Cost-of-Sales method,

a) Stock is NOT seen as part of the Trial Balance in real-time. A calculation on month-end and in many cases, at year-end, has to be done. You then have to enter a journal into the Trial Balance. Stock is thus divorced from the TB.

b) If the correct journals are not passed into the cost-of-sales section of the TB, the purchases for the months will cause the company to show a huge loss, every time stock is purchased. You may have shown an R 100 000.00 Profit for the month. When the stock is booked in via a Goods Received note, let's say R 110 000.00 worth, you will show a R 10 000.00 loss for the month. This is confusing and inaccurate.

c) This method contradicts the benefits of modern computerized accounting, in that you now have to rely on manual systems to balance your TB. This can be very risky as mistakes are often made.

4. <u>How does the Automated Cost-of-Sales work</u>

When using the automated Cost-of-Sales Engine in modern accounting packages, stock is no longer seen as an Expense (via purchases). Rather, when stock is booked in, it is booked under the ASSETS portion of the Trial Balance. Using this method, even if you purchase a Million Rand's worth of stock on the last day of the month, it will NOT affect your profit and Loss statement by one cent. Looking at the Trial Balance, the stock is updated under the Assets called Stock Control. Only when the stock is sold, is it moved from the assets portion to the expense portion called cost-of-sales. This forms the one leg of the Gross Profit calculation. The Sales price on the item forms the other.

1) Stock is purchased, the following happens:
   a. Stock Control Account (Asset) Increases (Debited or +) by the value of the stock at cost.
   b. The Creditors Control Account (Liability) is Decreased (Credited or -) by the same amount.

2) When the stock is sold, the following happens:
    a. Stock Control Decreases (Credited or -) by the value of the stock (at cost) sold.
    b. The Cost-of-Sales account is increased (Debited or +) by the value of the stock at cost.

The difference between the Sales Value and the Cost-of-Sales is then the Gross Profit.

Thus, if we purchase ten items at R 1000.00 the following will happen:

I		No Movement on Income or Expenditure
E		
A	Stock Control	+ 10 000.00
L	Creditors Control	- 10 000.00

If we now sell 5 of the items at R 1500.00 each, the following will happen

I	Sales	- 7 500.00	
E	C.O.S	+ 5 000.00 ◄	(C.O.S. Increases by R 5000.00)
A	Stock Control	+ 10 000.00	
	Sales Journal	- 5 000.00	Stock Value reduces by R5000.00
L	Creditors Control	- 10 000.00	

The Stock Control Account Decreases by R 5000.00 and the Cost-of-Sales Account increases by R 5000.00. It is thus very easy to work out the Gross Profit by simply deducting the Cost-of-Sales from the Sales. Also, the value of the Stock will always be correct on the TB.

4.1. The Advantages of the Automated System

The Advantages of using Cost-of-Sales in the automated fashion are obvious:

a) Stock Purchases do not get expensed until they are sold. Thus the TB and Profit and Loss statements are automatically reflecting the correct Gross Profit.
b) The Stock is integrated with the TB. You do not have to manually journalise the figures into the TB from the Stock valuation reports.
c) You do not have to do any manual calculations to work out cost-of-sales.
d) Stock that is losses or damaged will automatically be processed into the correct expense accounts on completion of a stocktake.

4.2. The Disadvantages of the Automated System

Apart from the fact that you cannot see the stock purchases on the TB, there are **no** disadvantages. If you are interested in the purchases, simply print a purchase report, or, in the case of Revelation, simply click on the Dashboard button and look under the purchases section.

5. <u>How to turn on Cost-of-Sales in Revelation.</u>

Before turning on Cost-of-Sales in Revelation, we recommend that you have a chat to your auditors AND make sure that YOU HAVE A BACKUP. Did I mention the fact that A BACKUP IS A GOOD IDEA. O and don't forget to MAKE A BACKUP BEFORE YOU START. Further, we highly recommend that you switch on cost-of-sales just after a month-end was performed. For this month only, encourage your sales team not to process sales into the new month until you have completed the cost-of-sales switch-on.

Now, make sure that everyone is out of Revelation except for the user that will turn on cost-of-sales. Now select the system preferences under the system maintenance options.
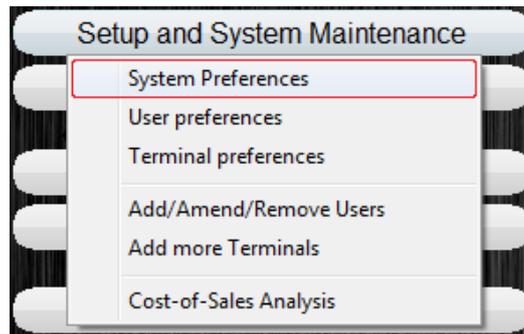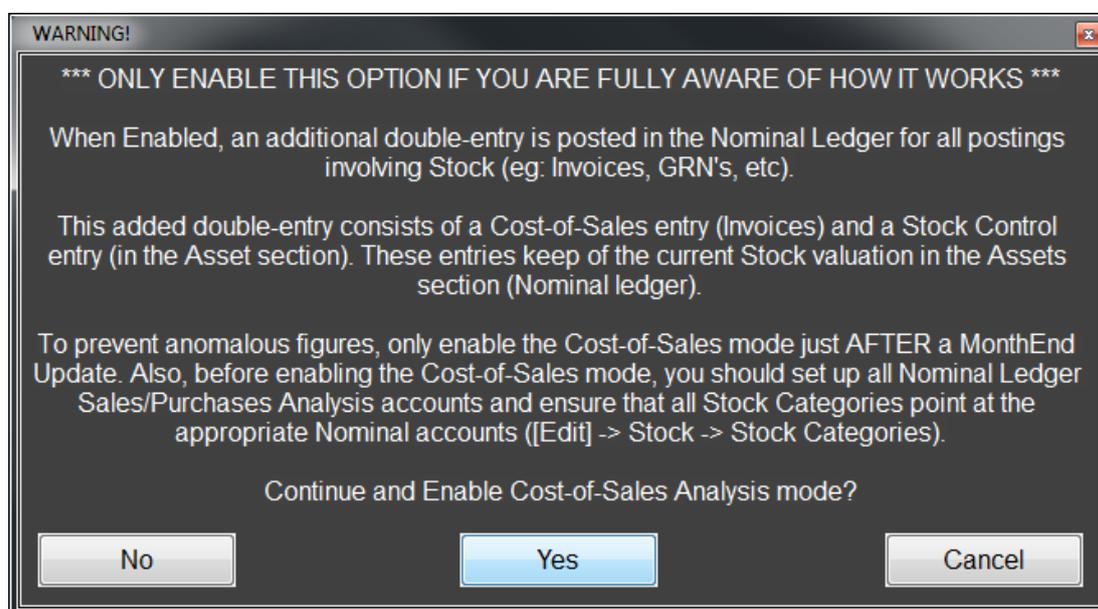

Now click on the [Stock] tab. You will notice that all the stock system settings will be displayed.
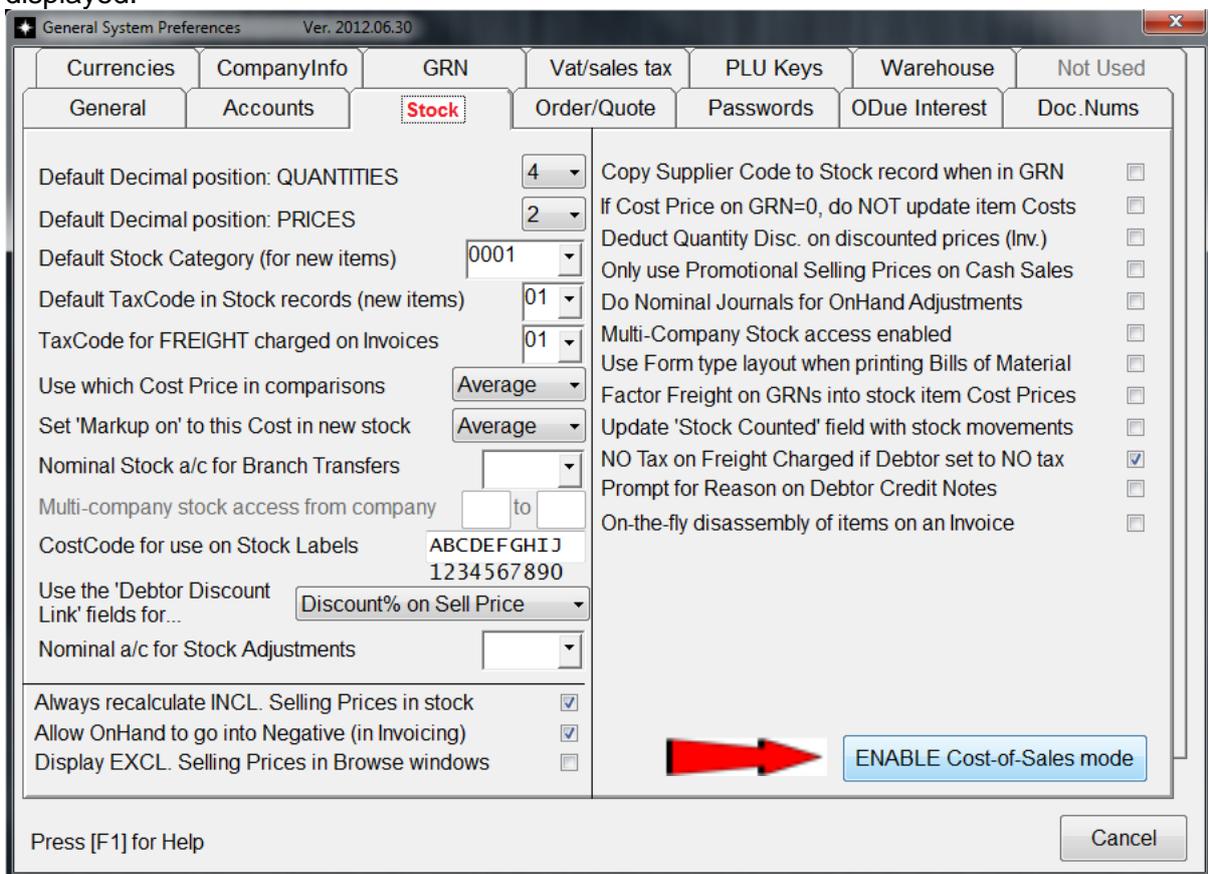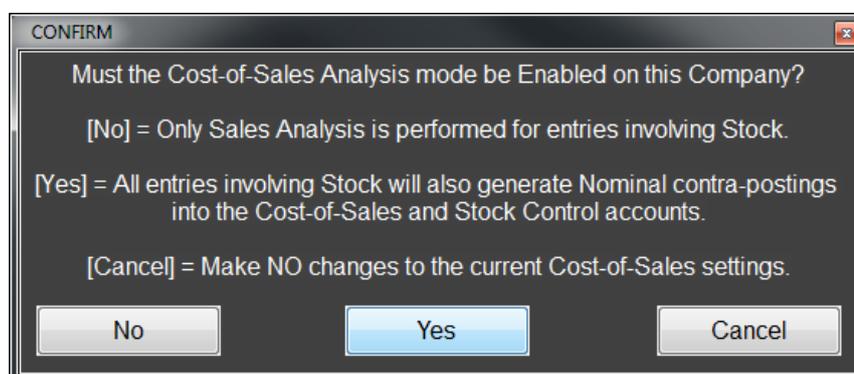
Look for and then click on the [ENABLE Cost-of-Sales mode] button. A set of confirmation screen will now come up. After reading each screen carefully, you may proceed to enable Cost-of-sales.
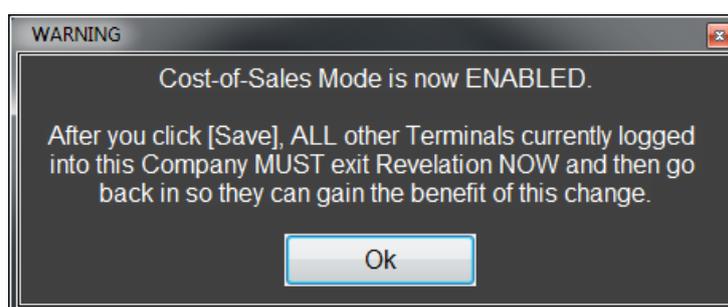
CONFIRM

*** ONLY ENABLE/DISABLE THIS OPTION IF YOU ARE FULLY AWARE OF HOW IT WORKS ***

Continue?

No   Yes   Cancel

As we are guiding you through this process, you may click on the [Yes] button, as we have explained the cost-of-sales consept to you and hopefully you understood. Again, carefully read the instructions in order to make sure you are ok with having cost-of-sales switched on in your orginisation.

WARNING!

*** ONLY ENABLE THIS OPTION IF YOU ARE FULLY AWARE OF HOW IT WORKS ***

When Enabled, an additional double-entry is posted in the Nominal Ledger for all postings involving Stock (eg: Invoices, GRN's, etc).

This added double-entry consists of a Cost-of-Sales entry (Invoices) and a Stock Control entry (in the Asset section). These entries keep of the current Stock valuation in the Assets section (Nominal ledger).

To prevent anomalous figures, only enable the Cost-of-Sales mode just AFTER a MonthEnd Update. Also, before enabling the Cost-of-Sales mode, you should set up all Nominal Ledger Sales/Purchases Analysis accounts and ensure that all Stock Categories point at the appropriate Nominal accounts ([Edit] -> Stock -> Stock Categories).

Continue and Enable Cost-of-Sales Analysis mode?

No   Yes   Cancel

Again, make sure that you would like to enable cost-of-sales now by clicking on the [Yes] button. Remember, this option is highly recommended by us!!!

CONFIRM

Must the Cost-of-Sales Analysis mode be Enabled on this Company?

[No] = Only Sales Analysis is performed for entries involving Stock.

[Yes] = All entries involving Stock will also generate Nominal contra-postings into the Cost-of-Sales and Stock Control accounts.

[Cancel] = Make NO changes to the current Cost-of-Sales settings.

No   Yes   Cancel

Once completed, you will receive a confirmation screen. To finish, click on the [Ok] button.

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Congratulation, Cost-of-Sales is now active on your company. From now on you should be able to track your exact Profit as well as the correct stock holding via the Trial Balance. Well done.

5.1. Posting a stock valuation update journal

It is important to take note that Revelation does not automatically update the stock from the manual system to the now enabled cost-of-sales system. Due to the fact that you have not treated your stock as a live TB item, and especially if you have not used the opening/closing journals to update your stock, changes are that you have overstated your expenses by declaring stock purchases as an expense on the TB. In order to rectify the situation, you should now post a stock valuation journal into the TB. The theory is that all the stock that you currently have, was purchased in the current financial year. Therefor the current expensed were overstated by the value of the current stock at cost. Stock that was not purchased in this financial year will be adjusted via a secondary journal that will be explained later on. To rectify the stock on the TB and the same time correct the overstated expenses by the same amount, Revelation has an automated Journal that will calculate the stock values from the stock valuation Report and post this accordingly.

From the Daily options menu, go to the Postings to accounts button. Now select the [Nominal Ledger] button.
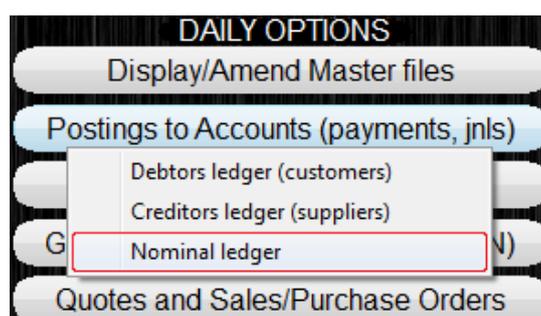

Now click on the [Postings] option and look for the [Post a Stock Valuation update Journal] button. This will calculate the current stock value and post a Journal between the stock Adjustment Account (23560 or 28100 depending on the age of your system).
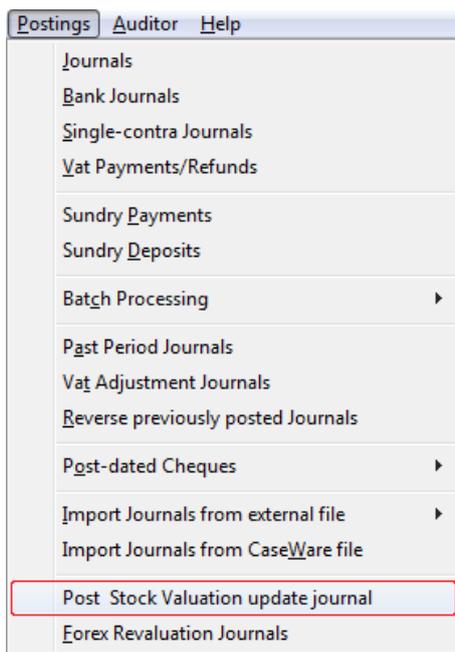
Depending on the system setting on how stock should be handled under comparatives (See Setup>>System Preferences>>Stock), Revelation will either post this Journal under the Average (Recommended) or Latest cost price. Please click the [Yes] button to proceed.
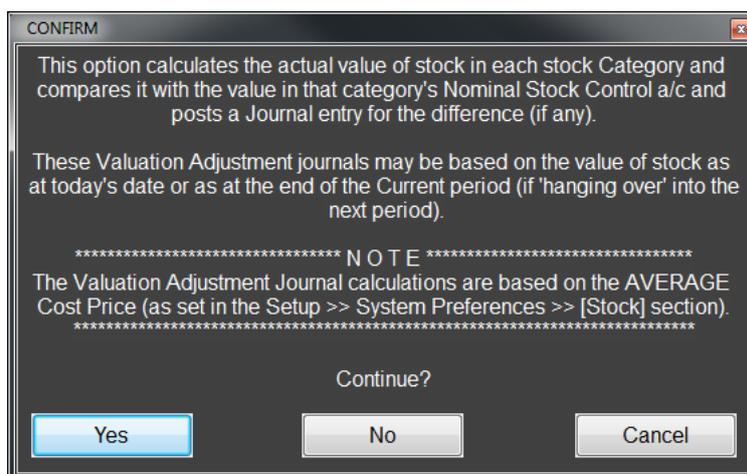
Please make sure that ALL OTHER USERS ARE LOGGED OUT before you process this journal.
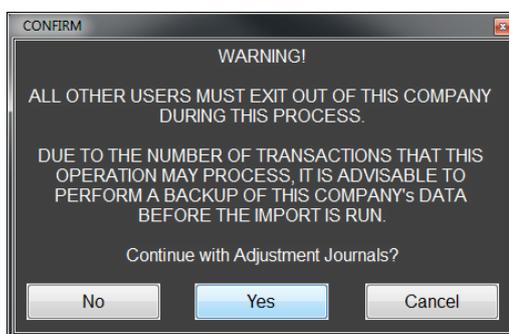
You may now select if the journal is at today's date (recommended) or as at the end of the current period (This is were you are haning over from a previouse month (not Recommended).
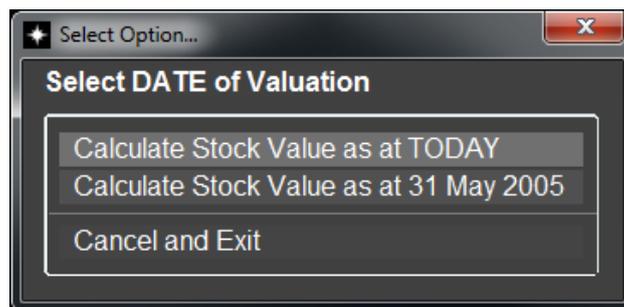
Revelation will now calcualte the value of the journal (stock Value) that it is going to be posting into the Stock Control and Stock Adjustment accounts. Make sure that this figure balances with your stock valuation report for the same period (if hanging over).
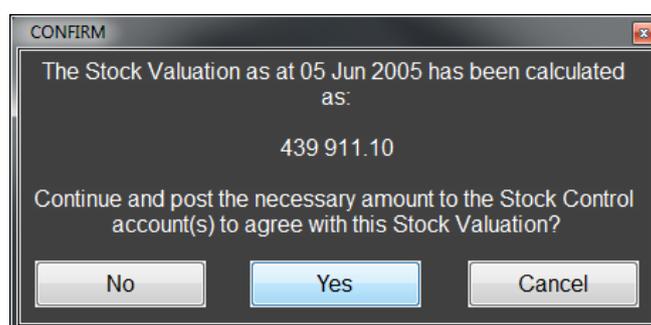
Once you are satisfied that this is the correct amount, you may continue by pressing the [Yes] button. This will now process the journal. Once complete, you will receive the following confirmation screen.
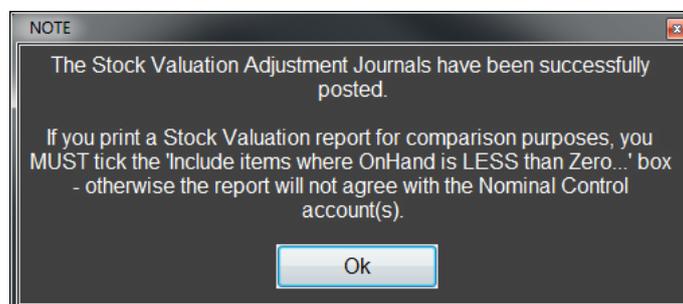
To finish, click the [Ok] button.

Now, the portion of the expence account that was incorrectly Credited with the value of the stock that was placed into the Stock Control account, but was purchased in a previouse fianacial year, must now be journalised out of the Stock Adjustment accountinto the Retained Income or Year-end appropreation account. The reason for this is obviouse, this is the acccount that gets debited or credited at year end in order to clear the Income and expense account in order to start a new financial year. Because the stock was purchased in a prior year, it makes sence that the journal should also be contrad to this account. In many cases, the entire amount in the Stock Adjustment account must be cleared out. Speak to your auditors or give us a call, in order to find out more about this journal.

You may also call Vernon directly on 0834584847