There will be an overstatement or understatement of beginning or ending inventory. You can memorize the table below OR just memorize the Cost of Goods Sold formula and figure it out, which is probably easier. Simple formula, simple math

INCOME STATEMENT EFFECTS

Inventory errors affect the computation of cost of goods sold and net income.

ILLUSTRATION 6B-1
Formula for cost of goods sold

Beginning Inventory + Cost of Goods Purchased − Ending Inventory = Cost of Goods Sold

Inventory Error	Cost of Goods Sold	Net Income
Beginning inventory understated	Understated	Overstated
Beginning inventory overstated	Overstated	Understated
Ending inventory understated	Overstated	Understated
Ending inventory overstated	Understated	Overstated

Cost of Goods Purchased is simply additional purchases

It is easier to remember formula then above chart
Its basic math, think about it…

BEG inventory + COG purchased - Ending Inventory = COGS

If this is overstated (too high)
If this is understated (too low)

then COGS overstated
then COGS understated

Example:

Lets say COGS is 300:

400 – 200 = 100 but by error you either:

500 (overstated) - 200 = 300
300 (understated) – 200 (no change) = 100

Now you can clearly see that when beg inventory is overstated COGS is understated or when Beginning inventory in understated that COGS is overstated.

How does this effect Net Income?

Go to Net Income Statement

PROFIT & LOSS		
REVENUE	Dr	Cr
Sales		
Sales Rtn Allow		
Cost of Goods Sold	too high	
Other Revenue& Gains		
Gain on disposal of asset		
EXPENSE		
Advertising		
Depreciation		
Other Expense&Losses		
Loss on disposl of asset		
= NET	**LOSS**	**GAIN**

Why?

Because COGS falls under the Revenue Account on the Net Income Statement.

Remember what you are really ULTIMATELY CALCULATING is your PROFIT

How much did you make after you paid for you inventory?

Sales Revenue – COGS = Gross Profit

Again,

basic math iF the COGS number is high then you make less Profit

so your NET INCOME IS UNDERSTATED

<u>Or focusing on ENDING INVENTORY</u>

BEG inventory + COG purchased - Ending Inventory = COGS

If this is overstated (too high) then COGS understated
If this is understated (too low) then COGS overstated

PROFIT & LOSS		
REVENUE	Dr	Cr
Sales		
Sales Rtn Allow		
Cost of Goods Sold	too low	
Other Revenue& Gains		
Gain on disposal of asset		
EXPENSE		
Advertising		
Depreciation		
Other Expense&Losses		
Loss on disposl of asset		
= NET	**LOSS**	GAIN

Notice COGS iNCREASES on the debit side

If COGS is understated then Revenue will actually be higher than it should be

If Revenue is higher then Net Income is overstated

COGS is not really a Debit or Credit Balance. It is merely subtracted out from Sales to get your profit.

Sales is a Credit balance If you add stuff up in the CREDIT column you get a Net Gain