

What Is an Inventory Adjustment?



Effective inventory control is one of the most important ways your business can ensure the financial information you rely on for reporting, forecasting, and auditing purposes is complete, accurate, and up-to-date.

And one of the most critical parts of any successful inventory system is the use of *inventory adjustments*.

The process itself is not terribly complicated, but ensuring it's done properly can save you from needless frustration and costly delays in today's data-driven business environment.

Inventory Adjustments: An Overview

Changes in inventory levels don't always come from sales. Sometimes, it's necessary to modify inventory levels to reflect changes in your actual inventory count that might not be in your records.

Inventory adjustment refers to adjustment entries made in periodic accounting to account for differences between recorded and actual inventory items.

Adjustment reasons vary. Positive inventory quantity adjustments are often due to the simplest: the addition of more inventory from production, or excess inventory

that remains saleable, but did not sell.

On the other hand, negative inventory quantity adjustments are often required to address:

- **Waste:** Expired or obsolete inventory (common in food and consumer goods).
- **Breakage:** Damaged inventory that cannot be legally sold as new.
- **Shrinkage:** Inventory lost to theft. Also called “stockloss.”
- **Write-offs:** Inventory lost to other reasons.
- **Internal Use:** Inventory items put to internal use or consumed by the company instead of being sold to the customer.

With manual inventory processes, some of these changes may not be noticed, let alone recorded, until a scheduled inventory count is performed.

The adjustments recorded during such a count include specific information for each affected item, such as unit cost, number of items, etc., and will be used to calculate the actual value of current inventory so accounting can accurately calculate cost of goods sold (COGS).

If your business uses the *periodic method* of accounting (also called the *periodic system*), your inventory counts record only the cost of the previous year’s inventory and do not change.

Instead, production and inventory-related purchases made during the current accounting year are logged in a temporary account used to make the necessary adjustment entries during the closing of accounts at year end.

When your accounting team is finalizing your records for the current year, inventory adjustments are used to modify the beginning balance in the Inventory account to reflect the cost of the ending inventory.

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Why Inventory Adjustments Matter

Inventory fluctuations can wreak havoc on more than just your stockroom. When recorded inventory levels are lower than actual inventory counts (understated), the cost of goods sold rises artificially.

Conversely, when actual inventory levels are lower than those recorded (overstated), the inverse occurs, and COGS is artificially lowered.

In both cases, the adjusting entries necessary to reflect the true state of affairs can have a significant impact on your gross and net profits, your income statements, and, by extension, your company's competitive advantage, financial agility, and overall health.

Decision making, reporting, auditing, and budgeting can all be skewed to disastrous levels if your team is operating with incomplete or inaccurate information.

As a result, inventory adjustments are absolutely crucial to responsible and strategically viable accounting practices.

How to Make Inventory Adjustments

Imagine your company, Widgets, Inc., had a total cost of inventory (drawn from last year's ending inventory) of \$500,000 at the beginning of the accounting year.

This amount is "locked in" until year-end, when a physical inventory count is taken. The physical inventory count reveals an actual cost of \$570,000 for inventory.

As a result, the accounts team makes an entry to adjust inventory as follows:

- The Inventory account is *debited* for \$70,000.
- The Inventory Adjustment account is *credited* for \$70,000.

Widgets, Inc. also had a debit balance of \$3,500,000 in the temporary account called Purchases for the current year.

The Inventory Adjustment account is a special *income statement account*—one of

the accounts carried forward to the company's income statement from the general ledger—that, when added to the Purchases account, reveals the company's cost of goods sold.

To continue with our example, when the \$70,000 credit balance in the Inventory Adjustment account is applied to the debit balance of \$3,500,000 in Purchases, the result is a COGS total value of \$3,430,000.

$$\mathbf{\$3,500,000 - \$70,000 = \$3,430,000}$$

The next year, Widgets, Inc. conducts another inventory count and finds their actual inventory cost is \$320,000.

But because their inventory records listed a debit balance of \$570,000 last year, another inventory adjustment entry must be made:

The Inventory account is *credited* for \$250,000.

The Inventory Adjustment account is *debited* for \$250,000.

This year, Widgets, Inc. had a debit balance of \$3,250,000 in the Purchases account. Adding the debit amount in the Inventory Adjustment to the debit amount in Purchases produces a COGS value of \$3,500,000.

$$\mathbf{\$3,250,000 + \$250,000 = \$3,500,000}$$

Automation and AI Take the Stress out of Inventory Adjustments

As with most procurement and accounting processes, inventory adjustments are greatly simplified when supported by the use of a comprehensive procurement solution with an inventory management module.

With all your data in one convenient, cloud-based location, and total visibility into not just your transactional data, but inventory, supply chain management, and more, you can take a more active role in inventory management.

Automation supports alerts and automatic reorders for critical materials and other goods, while data analytics provide actionable insights that let you keep

your inventory control as lean and efficient as possible while still meeting your goals for production and profits.

Finally, by integrating with your accounting system, inventory management software lets you populate reports and perform calculations with confidence, knowing you're using complete and accurate data that reflects your actual inventory to calculate, record, and report the values that matter most to your company's ongoing growth and innovation.

Accurate Inventory Is Essential to Your Success

Like a ship sailing in a strong wind, inventory sometimes needs small adjustments to stay on course.

Understanding and applying inventory adjustments correctly ensures your company has the information it needs for accurate financial statements, better decision making, and process improvements—today, and in the future.

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