

Supplemental Handout for the “Taste of the Conference” Webinar

By Joe Woodard, Conference Host and Lead Presenter – “Scaling New Heights” - May 24-26, 2010

“Scaling New Heights” is an Advanced Training Conference on Intuit Software for QuickBooks ProAdvisors and Intuit Solution Providers. For more information about “Scaling New Heights” go to www.ScalingNewHeights.com

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Note: This handout is supplemental to the Intuit-published document entitled, "Ten Steps to Cleaning Up Your Client's QuickBooks Data." There is a link to this Intuit-published document on the "Free Webinar Series" page at www.ScalingNewHeights.com.

Appendix A: Troubleshooting Beginning Balances

Step 1: Use the Client Data Review utility to troubleshoot beginning balances

Step 2: If there are issues you cannot resolve using the Client Data Review utility, refer to the guide.

Appendix B: Cash Position/Bank Reconciliation

When does the bank reconciliation feature in QuickBooks confirm an accurate cash position?

1. Is the bank reconciliation current?
2. Is the beginning balance/ending balance accurate?
3. Was the bank reconciliation forced to reconcile?
 - a. With a user-created adjusting journal entry
 - b. With a QuickBooks auto-created adjustment to Reconciliation Discrepancies
4. Are there disbursements/deposits that need to be voided?

Appendix C: Undeposited Funds

How to know if a balance in Undeposited Funds is correct at year end?

Problem: There is no way to get a list of the open activity in Undeposited Funds as of a date in the past. If you double-click the balance on the Balance Sheet you get a detail report showing the correct ending balance, but the detail on the report doesn't show the same transactions as the "Payments to be Deposited" window would have shown as of that date.

To determine if a balance in Undeposited Funds is accurate you must:

1) Open the Payments to be Deposited window as of the current date to see if there is activity dated in the previous reporting period. Provided you open the window at least 10 days after the fiscal year end, all activity on the Payments to be Deposited window should be dated within the current year. If any transactions are dated in the previous fiscal year *and* cash position in the bank account is correct, use the steps in the guide to locate and troubleshoot.

2) Make sure cash position is accurate as of the current date. It is possible the client recorded erroneous deposits during the current year using Undeposited Funds from the previous year. If so, cash is probably overstated in the current year. However, if the current cash position is accurate *and* the client has not posted any adjusting entries to Undeposited Funds dated in the current year, it is unlikely they cleared the prior period Undeposited Funds erroneously. Conversely, if a current bank reconciliation reveals deposits in QB from Undeposited Funds that did not clear the bank, you will need to delete those deposits to re-insert the activity into the Payments to be Deposited window. You can then use the steps in the guide or the Client Data Review utility to troubleshoot.

Report Showing Deposits Not Coded to Undeposited Funds

Step 1. Select the Reports drop down menu and then select "Custom Transaction Detail report.

Step 2. Filter the report by transaction type for "Deposits."

Step 3. Filter by account for all accounts except bank accounts and the Undeposited Funds account.

Step 4. Filter by date for the fiscal year you are analyzing/troubleshooting.

Note: The transactions on this report are not necessarily incorrect. For example, deposits made from loans provided to the company by owners or other lending agencies, draws from a line of credit, etc. However, if any of the activity on this report reflects customer receipts and the company otherwise using Undeposited Funds consistently the deposit is probably recorded in error. Whatever account the deposit posted to creates an overstatement or understatement on the General ledger - offset by an overstatement in Undeposited Funds.

Appendix D: Supplemental Processes for Troubleshooting Inventory Asset

Tying the Balance Sheet to the Inventory Valuation Summary Report

If the balance in the Inventory Asset account does not tie to the total value of inventory on the Inventory Valuation Summary report check for the following probable causes of the discrepancy:

- Report Dates: Make sure the dates of the two reports are the same.
- Inventory Item Setup: It is possible that one or more Inventory Items (including Assembly Items) do not post to the correct Inventory account(s) in the Inventory Asset field. The item may also post to the "Inventory Asset" account(s) in the "COGS Account" or "Income Account" fields. To quickly locate these items, filter an Item Listing report by item for Inventory and Assembly Items. Then, show columns for the following fields: Inventory Asset Account, COGS Account and

Income Account. Sort by each of these accounts to quickly locate any incorrect accounts. For example, if you sort by the Inventory Asset Account column in ascending order, an Item with "Employee Receivables" in that field will show above all of the Items with "Inventory Asset" in that field.

Note: It is possible for items to post to an incorrect account even if the correct accounts show on the item setup window. If a user enters an incorrect account in the item setup window, uses the item on one or more transactions and then corrects the item setup, QuickBooks prompts the user to update all existing transactions for the item or only future transactions for the item. If the user selects future transactions only, QuickBooks will continue posting to the incorrect account on existing transactions. To correct for this you can enter a journal entry (with a very specific memo) or you can remove the item from the historical transaction, save the transaction, re-insert the item and save again.

- **Other Item Types:** It is possible that one or more non-inventory Items (e.g. Service, Non-Inventory or Other Charge) post to the Inventory Asset Account(s). To check for this activity, create a Custom Summary report with the date range set to "All." Then, filter the report by account for the Inventory Asset account(s). Set the rows to display by "Item Type." All balances for Item types other than Inventory Items and Assembly Items are posting incorrectly to Inventory Asset account(s). You can double-click the balance to show more detail and to locate the specific items causing the problem. Note: You may see a line on this report titled "No Item." If so, refer to the bullet below.
- **Transactions Post Directly to Inventory Asset:** If a transaction posts directly to the Inventory Asset account without using an Inventory Item or Assembly Item, QuickBooks will not show the change in inventory value on the Inventory Valuation Summary report. To locate these transactions, use the Custom Summary Report you created in the bullet above and look for the "No Item" line. You can double-click the balance for this line to see specific transactions that post directly to Inventory Asset account(s).

Note: You may see one or more Inventory Adjustment transactions when you double-click on the "No Item" balance. If so, refer to the bullet below.

- **Inventory Adjustments:** Make sure inventory adjustments do not include an Inventory Asset account in the "Adjustment Account" field. If you use an inventory asset account in this field, QuickBooks treats the debit/credit to the adjustment account as a non-inventory post, not associated with an inventory or assembly item. To locate these transactions use the report you created in the bullet above and double-click on the "No Item" balance.
- **Inactive Inventory Items or Assembly Items:** Check for any inactive Inventory Part or Assembly Items with quantities on hand other than zero. If an inventory part is inactive QuickBooks will not include the part on the Inventory Valuation Summary Report - even if the inventory part impacts the value of inventory on hand.

Tying the Sales by Item Summary Report to the Profit & Loss

For management purposes it is best to use a separate Cost of Goods Sold account for Inventory tracking. If you mix a periodic and perpetual inventory system, separate the Costs associated with the periodic system into a separate account. If you track non-inventory costs (e.g. field labor costs) above Gross Profit and you do not absorb these costs into Inventory value (e.g. through an Assembly Item), use a separate Cost of Goods Sold account for these posts. Separating costs this way not only makes it easier to troubleshooting inventory, it makes it easier to manage the profitability for your inventory turns over selected date ranges. For periodic inventory, separating costs into a separate account makes yearend adjustments easier and more accurate.

If you use a separate COGS account for Inventory and Assembly Items, the total costs on the Inventory Valuation Summary report should tie to the total of COGS for this account on the Profit & Loss. If the two do not agree, consider the following:

- Report Dates: Make sure the date ranges for the two reports are the same.
- Inventory Item Setup: See the second bullet in the section above for more information.
- Other Item Types: See the third bullet in the section above for more information. Note: if the non-inventory part items are part of a periodic inventory system, consider using a separate COGS account for those items. If you prefer these items to use the same COGS account as the Inventory and Assembly items, filter the Profit & Loss report by Item for "All Inventory and Assembly Items."
- Transactions Post Directly to COGS. To quickly locate these transactions, create a Custom Summary Report. Show rows by Item Type. Filter by account for the COGS account(s). If transactions post directly to COGS QuickBooks will show a "No Item" line with a balance. Double-click this balance to locate the transactions. You can edit each transaction (preferred) or enter an adjusting entry to compensate. If the non-inventory transaction should increase/decrease costs consider posting to a different COGS account than you use for inventory tracking.

Note: Inventory Adjustments may show as part of this "No Item" balance. When you adjust inventory it is best to use a separate COGS account. One commonly used account name for this cost account is "Inventory Variance."

Negative Inventory

Ideally, inventory counts in QuickBooks should never show a negative quantity on hand - even temporarily. The second below on "Troubleshooting Average Cost" covers the ramifications in more detail.

Check for negative inventory on hand as often as possible. You can create an Item Listing report.

Option 1: Filter the report by Item Type for "All Inventory and Assembly Items" and by Quantity on Hand for less than or equal to 0.00. (Note: The report will not populate accurately if you enter "-1" in this field.) Add a column for the Quantity on Hand on sort by that column in Ascending order. All items with

negative quantities on hand will show on the top of the list. (Note: This report reflects all transactions in the file: past, present and future. There is no way to filter this report by date.

Option 2: Create a Stock Status by Item Report. You can set the date range to "All" to reflect all activity or you can set the range to 01/01/1970 through "today" if you want to exclude future-dated transactions. Click "Export" at the top of the report. When the Export Report window appears, click the Advanced tab and then click "Auto-Filtering." Once in Excel, click the filter drop down menu to the right of the Quantity on Hand column, select "Number Filters" and then select "Less Than." Enter "0.00" and click OK. QuickBooks will show all Inventory Items and Assembly Items with a negative quantity on hand.

Note: Even if the current quantity on hand is 0 or greater, the item could have had a zero quantity on hand at some point in the past. If so, this negative inventory event could cause the current quantity on hand to be understated, could cause costs to show as Unclassified on the P&L by Class and could cause Costs not to show on the P&L by Job. Costs could also post to incorrect fiscal periods. To locate these historical negative quantities on hand create an Inventory Valuation Detail report and set the date range as far back into the past as you deem necessary for your analysis. To catch everything you can run the report from the first date of QuickBooks use through the present day, but on future checks you can limit the range of the report to the last 12 months or last 6 months. After you create the report, export the report to Excel and use the Auto-Filtering options described in Option 2 above to filter the report for negative quantities on hand.

The ideal solution - for negative inventory is an inventory adjustment dated the same day the inventory went negative. However, this ideal solution is not always practical. If you enter a back dated inventory adjustment, the adjustment could affect the valuation of inventory for all subsequent transactions that include that inventory item. Before entering back-dated inventory adjustments (especially for the previous fiscal year) read the section below on "Troubleshooting Average Cost" and consult with your CPA or tax preparer.

Troubleshooting Average Cost

How QuickBooks Calculates Average Cost

For an inventory item, average cost is the total value of the items currently in stock divided by the quantity on hand. If you have a total Widget value of \$20.00 and 10 units on hand, the average cost is \$2.00 ($\$20.00/10$).

QuickBooks uses average cost—and not another method such as LIFO or FIFO—to determine the value of your inventory.

Note: This section covers the calculation of average cost for normal and intended QuickBooks use devoid of user entry errors or data file setup errors. The rest of this topic covers the aberrations involved due to user error or changing list information and/or historical transactions.

QuickBooks recalculates average cost during normal QuickBooks use in the following ways:

- **When you record the purchase of an Inventory Part Item or the purchase of an Inventory Assembly Item.** QuickBooks adds the cost of the new items to the cost of the existing stock and then divides by the total number of new and old items. If the per-unit cost of the Inventory Part or Assembly Item you purchase is the same as the current average cost, the average cost recalculation will not cause any change. For example, assuming you have no quantities of widgets on hand, if you purchase 10 widgets for \$2.00 per widget the average cost is \$2.00. If you then purchase 8 more widgets at \$2.00 per widget, QuickBooks will re-calculate average cost but the calculation will not cause any change to average cost for the widgets on hand. The average cost for widgets will remain \$2.00.
- **When you change the value or quantity of an Inventory Part Item or Inventory Assembly Item using an Inventory Adjustment.** As with a purchase, an inventory adjustment will or will not cause a change to average cost for an item, depending on how you adjust the quantities and total value for each part. On an inventory adjustment you can preserve the average cost if you change the quantity on hand and value proportionally. For example, if you have 10 widgets with an average cost of \$2.00, the total value is \$20.00 ($\2.00×10). If on an Inventory Adjustment you change the quantity of widgets to 20 units and the total value to \$40.00, QuickBooks recalculates average cost, but the average cost does not change. The average cost is still \$2.00 ($\$2.00 \times 20 = \40.00). By way of contrast, if you change the quantity on hand for widgets to 20 but leave the total value at \$20.00, the average cost will change to \$1.00 ($\$1.00 \times 20 = \20.00)
- **Record a build of an Inventory Assembly Item.** This calculation is the most complex around Average Cost because there are multiple average costs involved. As with the first two examples the build will cause average cost to recalculate, but may or may not change average cost. QuickBooks considers the following around average cost when you record a build transaction:
 - **The average cost of each Inventory Part Item in the Bill of Materials.** To calculate the value of the Inventory Assembly Item you are building, QuickBooks uses the average cost for each Inventory Part Item in the Bill of Materials as of the date and time you record the build. For example, you can build 1 Assembled Gadget from 1 unit of "Widget A", 1 unit of "Widget B" and 1 unit of "Widget C". If each of the Widget items (components) has an average cost of \$1.00 QuickBooks calculates a \$3.00 cost for the one Assembly Gadget you build ($\$1.00 + \$1.00 + \$1.00 = \3.00).
 - **The average cost of any Gadgets already in stock.** Then, QuickBooks absorbs this \$3.00 Gadget into the average cost of existing Gadgets on hand. (This is similar to how QuickBooks recalculates average cost when you purchase a new inventory part, only you are building rather than purchasing.) For example, if you have 2 Assembled Gadgets on the shelf with an average cost of \$2.00 per gadget, the total value of the assembled gadgets on hand is \$4.00 ($\2.00×2). If you assemble 1 new gadget (as described above) and the per-unit value of the 1 newly assembled gadget is \$3.00 you add \$3.00 of value to the assembled gadgets on the shelf and one unit to the on hand quantity. You now have 3 assembled gadgets in stock ($2 + 1$) with a total value of \$7.00 ($\$4.00 + \3.00).

The average cost for all gadgets in stock will be the new value (\$7.00) divided by the new quantity (3), or \$2.34.

Note: The calculation of the value assigned to Inventory Assembly Items during a build can be much more complex than the example above. For example, the Bill of Material for the Inventory Assembly Item can contain Non-Inventory Part Items, Service Items and Other Charge Items. Since these items are not related to inventory and do not factor into average cost, QuickBooks uses the values you enter into the Bill of Materials as part of the value of the assembled item - arbitrarily. For example, if in the Bill of Materials for an Assembly Item you include \$1.00 of labor (Service Item) and \$1.00 of overhead (Other Charge Item), QuickBooks will add \$2.00 to the value of each Assembled part you build. If you build 1 part, QuickBooks adds \$2.00 to the value. If you build 2 parts, QuickBooks adds \$4.00 of value. The General Ledger posts are a debit to Inventory Asset and a credit to the accounts in the Service Item and Other Charge Item.

Note: As the most complex build scenario, you can include an Assembly Item in the Bill of Materials for another Assembly Item. However, this calculation is not as complex as it sounds. It is actually very similar to use of an Inventory Part Item in the Bill of Materials. Each Assembly Item in stock has an average cost. When you use the Assembly Item in the Bill of Materials for another Assembly Item, QuickBooks uses the average cost of the Assembly Item (component) and the Inventory Part Item (component) in the same way – based on the average cost of the component as of the date and time you record the build.

Average Cost and the Sale of Inventory

Note: This section covers the role that average cost plays in the normal and intended use of QuickBooks devoid of user entry errors or data file setup errors. The remaining sessions of this topic cover the aberrations involved due to user error or changing list information and historical transactions.

The sale of Inventory Part Items and Inventory Assembly Items does not change average cost. However, average cost does play a key role. QuickBooks posts a credit to Inventory Asset and a debit to Cost of Goods Sold for each inventory item you enter on a sales form. QuickBooks calculates this post to Inventory Asset/Cost of Goods Sold using the average cost of the item as of the date and time you record the sales transaction.

For example, if you record an invoice for the sale of 3 Widgets at \$10.00 per Widget (\$30.00 total) and the Widgets have a \$2.00 average cost, QuickBooks will post the following to the General Ledger (assuming no sales tax or other charges):

Account	Debit	Credit
Accounts Receivable	30.00	
Cost of Goods Sold	6.00	
Inventory Asset		6.00
Income		30.00

The average cost for the Widgets does not change because the quantities decreased proportionally to the value. For example, 10 Widgets with a total value of \$20.00 have an average cost of \$2.00. 7 widgets with a total value of \$14.00 have the same average cost of \$2.00.

The Perpetually Posting Nature of Average Cost

QuickBooks is a perpetually posting system – meaning that every transaction remains active in the database. QuickBooks then refers to these individual transactions when calculating average cost as well as the values Transaction Summary and Detail reports.

For example, QuickBooks computes the balance in a bank account on the Balance Sheet by totaling the individual banking transactions with all of their increases (debits) and decreases (credits). If there are 10,000 transactions for the account, QuickBooks refers to each of the 10,000 transactions individually each time you create a Balance Sheet. QuickBooks does the same when computing the Beginning Balance on a bank reconciliation, only for this calculation QuickBooks excludes historical transactions that are uncleared.

The same principle applies to average cost. QuickBooks considers every increase and decrease in value and quantity on hand for the entire history of the item when computing average cost. By concept, the average cost resets each time the quantities on hand are zero. When computing average cost manually (e.g. to proof the QuickBooks calculation) you only need to factor in the changes to quantity and value since the last time the product had 0 quantities on hand. However, QuickBooks considers the *entire item history* in its calculation.

Tip: If you want to reset the history for an item that has zero quantities on hand, first edit the name of the existing item (e.g. by adding a “-old” suffix to the name). Then, make the old inventory item inactive and create a new inventory item to replace the old inventory item. Each time the user selects the item on a purchase or sales form QuickBooks will use the new item you create. Historical average cost will calculate as of the date of the first purchase transaction or inventory adjustment for the item that increases the quantity on hand. Consider that you will need to edit memorized transactions, item-specific memorized reports and the Bills of Materials in Assembly Items so they refer to the new item rather than the old. As a result, this re-set option may not be practical for clients who need to make changes both items and the associated memorized reports/transactions and lists.

Impacting the Average Cost Timeline

The computation of average cost is perpetual and can change day by day, hour by hour or even minute by minute as users change the quantities and/or value of inventory on hand in all of the ways described above.

Because the calculation of average cost is dynamic – not static – the date and time you record inventory transactions (especially sales and build transactions) will impact the debits and credits to Inventory Asset and Cost of Goods Sold.

Consider the following timeline

February 1 – Enter a Bill to receive the initial stock of 10 Widgets at \$2.00 per Widget creates a total value on hand of \$20.00 and an average cost of \$2.00.

February 2 – Enter an Invoice to sell 3 Widgets at \$10.00 per Widget. The debit to Cost of Goods Sold and the credit to Inventory Asset are in the amount of \$6.00 (3 Widgets at \$2.00 each = \$6.00). 7 units remain on hand with an average cost of \$2.00 per unit or \$14.00 in Widget value on hand.

February 3 – Enter a Bill to receive additional stock of 10 Widgets at \$3.00 per Widget. The Bill increases the value on hand by \$30.00 for a total value on hand of \$44.00 (\$30.00 + \$14.00). The quantity on hand increases to 17 (7 + 10). \$2.59 is the new average cost (\$44.00/17).

February 4 – Enter an Invoice to sell 3 Widgets at \$10.00 per Widget. The debit to Cost of Goods Sold and the credit to Inventory Asset are in the amount of \$7.77 (3 x \$2.59).

This timeline is very straight forward. However, consider that the debits to average cost and inventory asset on the invoices is dynamic, not static. So, any change to the average cost timeline for the Widget causes a cascading change to subsequently dated transactions that include the Widget.

See the modified timeline below where all changes to the timeline are bolded

February 1 – Enter a Bill to receive the initial stock of 10 Widgets at \$2.00 per Widget creates a total value on hand of \$20.00 and an average cost of \$2.00.

February 2 – Enter an Invoice to sell 3 Widgets at \$10.00 per Widget. The debit to Cost of Goods Sold and the credit to Inventory Asset are in the amount of \$6.00 (3 Widgets at \$2.00 each = \$6.00). 7 units remain on hand with an average cost of \$2.00 per unit or \$14.00 in Widget value on hand.

February 3 – Enter a Bill to receive additional stock of 10 Widgets at \$3.00 per Widget. The Bill increases the value on hand by \$30.00 for a total value on hand of \$44.00 (\$30.00 + \$14.00). The quantity on hand increases to 17 (7 + 10). \$2.59 is the new average cost (\$44.00/17).

February 4 – Enter an Invoice to sell 3 Widgets at \$10.00 per Widget. The debit to Cost of Goods Sold and the credit to Inventory Asset are in the amount of **\$6.00** (3 x **\$2.00**).

Historical Impact

February 5 – A user edits the Bill recorded on February 3 so that it is now dated February 5. The increase in Average Cost from \$2.00 to \$2.59 is now dated after the date of the February 4 invoice.

Common Use Errors Related to the Average Cost Timeline

The change to the date of the bill in the scenario above is a very simple historical change to average cost. As users make changes farther and farther into the past, the greater the cascading impact you will see on various reports including the Profit & Loss, Balance Sheet and Inventory Valuation Summary

reports. This segment cover the most common changes users make to historical average cost and the impact of these changes on the General Ledger and on inventory valuation.

Note: Not all changes to the average cost timeline create inventory problems. For example, most accounting professionals are not concerned with the small change in the example above to average cost that impacts sales from one day in the past and for an immaterial amount. However, edits to historical inventory adjustments and purchase transactions (even those dated very recently) can cause inventory to show negative quantities on hand and the resulting impact on the file can cause other reporting issues, including distorting Profit & Loss by Class and Profit & Loss by Job reports. See the section on negative inventory below for more information.

Entering an Inventory Adjustment Dated in the Past

When you enter an inventory adjustment dated in the past, QuickBooks re-calculates average cost not only as of the date of the inventory adjustment but also for all transactions dated after the date of the inventory adjustment. Consider the change that a back dated Inventory Adjustment entered on February 5 and dated February 1 will have on average cost. All changes to the timeline are bolded below.

February 1 – Enter a Bill to receive the initial stock of 10 Widgets at \$2.00 per Widget creates a total value on hand of \$20.00 and an average cost of \$2.00. **Back-dated Inventory Adjustment changes the average cost to \$1.33 (\$20.00/15).**

February 2 – Enter an Invoice to sell 3 Widgets at \$10.00 per Widget. The debit to Cost of Goods Sold and the credit to Inventory Asset are in the amount of **\$3.99 (3 Widgets at \$1.33 each = \$3.99)**. 12 units remain on hand with an average cost of **\$1.33** per unit or **\$15.96** in Widget value on hand.

February 3 – Enter a Bill to receive additional stock of 10 Widgets at \$3.00 per Widget. The Bill increases the value on hand by \$30.00 for a total value on hand of **\$45.96** (\$30.00 + **\$15.96**). The quantity on hand increases to **22 (12 + 10)**. **\$2.09** is the new average cost (**\$45.96/22**).

February 4 – Enter an Invoice to sell 3 Widgets at \$10.00 per Widget. The debit to Cost of Goods Sold and the credit to Inventory Asset are in the amount of **\$6.27** (3 x **\$2.09**).

February 5 – Enter an Inventory Adjustment dated February 1 that increases the quantity on hand for Widgets from 10 to 15 but does not change the total value.

Editing Historical Transactions to Change Quantities or Value on Hand

The one of the example above - an edit to the date of a Bill - changed the timeline for the calculation of average cost and had a cascading impact on a single invoice. The following edits to historical transactions will also change the average cost timeline, but may have a significant impact on historical reports – depending on the date of the original transaction and the nature of the change.

- Changing the Inventory Item on a purchase transaction (e.g. Bill) or inventory adjustment. If you change the increase in inventory quantity/value from “Widget A” to “Widget B”, QuickBooks will recalculate average cost and quantities on hand for all transactions using “Widget A” and/or

“Widget B” dated after the date of the transaction you edit. The change may also cause the Widget A item to have a negative quantity on hand at some point in the inventory timeline. See the section on the dangers of negative inventory below for more information.

- Editing the quantities and/or value of inventory on a purchase transaction (e.g. Bill) or inventory adjustment. These changes impact the calculation of average cost and will affect all transactions in the inventory item’s timeline dated after the date of the transaction you edit.
- Deleting or voiding a purchase transaction containing inventory parts and/or Assembly Items. Or, deleting an inventory adjustment.
- Changing the date of a purchase transaction containing inventory parts and/or Assembly Items. Or, changing the date of an inventory adjustment.
- Changing the date of a build transaction or deleting a build transaction. Build transactions affect Assembly Items in much the same way that Bills affect Inventory Part Items. The build increases the quantity on hand and usually increases the value of the Item. When you change the date of the build or delete the build you change the average cost timeline for the Inventory Assembly part – creating a cascading impact throughout the sales transactions that include the Inventory Assembly Item.

The Impact of Negative Inventory on Average Cost

QuickBooks allows you to record the sale of inventory on sales forms even if there is not a sufficient quantity on hand. For example, assume you have 10 Widgets on hand in QuickBooks and you sell 15 Widgets – on an Invoice dated February 10. Obviously the QuickBooks quantity was understated because the additional 5 units were on the shelf. The sale is at \$10.00 per Widget for a total sale of \$150.00 (15 x \$10.00)

QuickBooks will allow you to record the sale of all 15 units even though QuickBooks shows only 10 on hand. The resulting quantity on hand will be -5. (10-15). Since QuickBooks doesn’t know the actual cost for the 5 additional inventory items, the program “guesses” at the average cost and bases the guess on the average cost for the most recent quantities on hand. In this example the 10 Widgets have an average cost of \$2.00, so QuickBooks will record the sale of the 5 additional units with a \$2.00 average cost as well. The cost attributed to the sale will be \$30.00 (15 Widgets x \$2.00 Cost per Widget)

QuickBooks will post the following to the General Ledger (assuming no sales tax or other charges):

Account	Debit	Credit
Accounts Receivable	150.00	
Cost of Goods Sold	30.00	
Inventory Asset		30.00
Income		150.00

Here comes the interesting part. To compensate for the guess made on the invoice, QuickBooks patiently waits for a replenishment of stock – for example on a Bill or Inventory Adjustment.

You now enter a bill dated February 15 and receive 20 Widgets at \$3.00 per Widget. The negative inventory quantities on hand for the Widgets create two problems at this point.

- Even though the quantity on hand is no longer negative, the quantity is still understated. Since the starting quantity was -5, the increase of 20 brings the total on hand to 15 (20-5) instead of the 20 you just received.
- Since QuickBooks now has a per-unit cost (e.g. average cost) for the additional 5 units, the program compensates for its guess on the invoice by adjusting Cost of Goods Sold and Inventory Asset on the Bill. The Bill should Debit Inventory Asset for \$60.00 (20 Widgets x \$3.00 per Widget) and credit Accounts Payable for \$60.00 to offset. This post still happens, but an additional debit to Cost of Goods Sold and offsetting credit to Inventory asset also post to the General Ledger – to compensate for the incorrect guess on the invoice. In this example, the additional inventory post will debit Cost of Goods Sold by \$5.00 and credit Inventory Asset by \$5.00. (\$3.00 per Widget Actual Less \$2.00 per Widget recorded on the Invoice = \$1.00 per Widget. \$1.00 x 5 Widgets = \$5.00)

QuickBooks will post the following to the General Ledger (assuming no or other costs on the bill):

Account	Debit	Credit
Inventory Asset	60.00	
Cost of Goods Sold	5.00	
Inventory Asset		5.00
Accounts Payable		60.00

Note: Assuming these adjustments to Cost of Goods Sold are material, the debit to Cost of Goods Sold on in this scenario causes several reporting issues. First, the income and associated cost may not be in the same reporting period. If the company manages profitability on a daily or weekly frequency this dating problem with Cost of Goods Sold becomes even more significant. Second, the cost is not assigned to the customer/job from the sales transaction. This will cause the Cost of Goods Sold to drop from the Profit & Loss by Job report and there is no way to assign a Customer/Job name to this post. You will have to transfer the costs to the applicable Customers/Jobs using a journal entry. However, determining the applicable Customers/Jobs is very difficult and time consuming. Third, QuickBooks does not associate the costs with the class used on the sales transaction. The subsequent impact on the Profit & Loss by Class report is similar to the impact on the Profit & Loss by Job report. The Cost of Goods Sold posts will show in the Unclassified column on the Profit & Loss.

Tip: You can use the Unclassified column on the Profit & Loss by Class report to quickly locate the transaction on which QuickBooks made corrective adjustments to Cost of Goods Sold for negative inventory. You can then run an Item detail report on the Inventory Item to determine when the item had a negative quantity on hand. If you enter an inventory adjustment to zero the quantity and you date the inventory adjustment at least one day prior to the date the inventory went negative, QuickBooks will remove the Cost of the Goods Sold adjustment from the bill and will make the adjustment on the sales transaction instead. This is the most surgical way to fix this problem with average cost and Cost of Goods Sold, but it is also the most time consuming.

A Note about Merging Inventory Items

When you merge two inventory items, you consolidate their average cost timelines into a single item record. This change to the inventory item's timeline will likely have the following impact on historical transactions:

- QuickBooks will post different amounts to Cost of Goods Sold and Inventory Asset for each sales of the now merged item record.
- If either or both of the items have or had negative quantities on hand, the consolidated item may cause the negative quantity histories for either or both items to evaporate – causing QuickBooks to shift posts to Cost of Goods Sold from purchase forms/inventory adjustments to sales forms. The inverse could also be true. The inverse is also true – where the consolidated part record could have negative quantities on sales transactions where this did not previously occur – causing posts to Cost of Goods Sold to shift from sales transactions to purchases and inventory adjustments.
- If the inventory item is used as a component of an Assembly item, the change will impact the average cost of the Assembly Items as well and could cause some existing build transactions to be parked as Pending. You can only build Assemblies in QuickBooks if you have sufficient quantities on hand for each component (each item in the Bill of Materials). If the merger causes the combined part to have negative quantities on hand at different places in the inventory part's timeline, pending builds may result. If the builds are now pending, the quantities on hand for Assembly Items could also go negative, causing future build transactions to show compensating entries to Cost of Goods Sold and Inventory Asset.

Simple Conclusion: Don't merge Inventory Items under almost any circumstances, especially when the Inventory Part Items are in historical transactions dated 30 days or more in the past or if either of the items you are merging is included in the Bill of Materials for one or more Assembly Items.

Appendix E: Tying Income on the P&L to Sales on Sales Reports

Premise and Introduction

QuickBooks reports are largely based on two different lists – Accounts and Items. QuickBooks uses the Chart of Accounts and the Trial Balance balances to generate financial reports like the Balance Sheet and Profit & Loss. QuickBooks also uses the Chart of Accounts for the General Ledger and other standard financial reports like those found in any accounting software product.

QuickBooks uses Items to create sales reports like the Sales by Item Summary report and to calculate taxable and non-taxable sales on sales tax reports. For accounting professionals (e.g. tax preparers and CPAs) the interest is mostly related to the Chart of Accounts and the Account balances QuickBooks uses to create standard financial reports. However, most small businesses lean heavily on the Item-based reports to manage their businesses and also to file sales tax returns.

Tying Sales Reports to the Income Statement

QuickBooks tracks income in two different areas of the data file: Items and Accounts. As you might expect, the account activity affects the Profit & Loss. QuickBooks refers to Item-based income as “Sales.” QuickBooks uses Items to populate reports like Sales by Item Summary and Sales by Customer.

Ideally, all revenue should affect both an Item and an Income account. When revenue does not affect both an account and an item reference, it is important for you to quickly locate the offending transactions and make any necessary adjustments. Perform the following steps to analyze your client’s Income balances.

- Step 1. Create a Sales by Item Summary report. Then, filter the report to include only “All Ordinary Income Accounts.”
- Step 2. Create a Profit & Loss for the same reporting period as the Sales by Item Summary report.
- Step 3. Compare Total Income on the Profit & Loss to Total Sales on the Sales by Item Summary report. The only possible cause for a discrepancy is Debiting or Crediting Income Accounts on transactions other than Sales Forms (Invoices, Credit Memos and Sales Receipts).
- Step 4. To locate non-sales transactions that post to Income, QuickZoom on Total Income on the Profit & Loss report. Then, filter by Transaction Type for all types except Invoices, Sales Receipts and Credit Memos. The most common non-sales transactions that affect Income are:
 - a. Deposits (to record payments from customers)
 - b. Journal Entries (adjustments usually entered by the Company’s CPA)
 - c. The Receive Payments window (to record discounts given – contra income).

Note: When you locate the reasons for the discrepancy, you may or may not make changes. The intent here is to reconcile the two reports and make *necessary* changes to income or sales. If the non-sales form accurately posts to Income, you need only to note the amount so you can reconcile Sales (Items) to Income (Accounts) for the client. In the examples above, the Customer Payment that posts to Discounts Given and the Journal Entry to adjust income are probably accurate.

However, with Deposit transactions, the client may have entered Income on the Invoice and then applied the customer payment to the Invoice. Then, instead of using the customer payment on the Deposit (through Undeposited Funds), the client entered a Deposit that posts directly to Income. This causes an overstatement in Income for both the cash and accrual basis offset to an overstatement in Undeposited Funds. See the section on troubleshooting Undeposited Funds above for more information. If there is no overstatement in Undeposited Funds, the overstatement will probably be in cash. Either way, enter an adjusting entry to adjust Income and Undeposited Funds/Cash.

Tip: If filtering the Profit & Loss as described above doesn't fully reconcile the two reports, filter the Sales by Item Summary report for all accounts except Income accounts. (This is not a generic filter. You will have to select "Multiple Accounts" and then select every account in the Chart of Accounts with a non-income type.) Usually you will find several sales Items that do not affect income. Some of these may be accurate. For example, the client may use an Item on Invoices or Sales Receipts to receive prepayments from customers. If the Company uses the Accrual Basis, the offset should go to Unearned Income – an Other Current Liability account. For another example, contractors need an Item to show Retainage on Invoices – retainage owed to them by their customer. The Retainage Item should post to Retainage Receivable – an Other Current Asset account.

Warning: If you edit the Account field on Sales Items, your change could affect the previous reporting year.

Appendix F: Cost of Goods Sold Analysis Report - Inventory

Note: Use the report below to troubleshoot incorrect posts to Cost of Goods Sold if the client uses inventory items in QuickBooks. If the client does not use inventory items in QuickBooks use the steps in Appendix G below to analyze Cost of Goods Sold - only in Step 2 below double-click Total COGS on the P&L instead of Total Expense.

If the client records all inventory transactions correct and the client never posts directly to Cost of Goods Sold account (i.e. without using an inventory item), the report below will be blank. However, if any detail shows on the report you create below it means: 1) the client allowed the quantity on hand for an inventory part to become negative and/or 2) the client posted a transaction to Cost of Goods Sold without using an inventory item.

Step 1. Create a Profit & Loss report and then double-click Total COGS. QuickBooks creates a Transaction Detail report showing the posts to COGS.

Step 2. Filter the report by transaction type for all transactions except the following:

- a. Invoices
- b. Sales Receipts
- c. Credit Memos
- d. Inventory Adjustments

Step 3. If any transactions show on the report review the transaction to make sure the post to COGS is appropriate.

Note: If bills, checks or credit card charges show on the report and these transactions include posts to COGS from inventory items, the client allowed inventory to have negative quantities on hand. See the section on troubleshooting inventory above - in these appendices - for more information.

Appendix G: Expense Account Analysis Report

For the most part (and there are exceptions) a company will consistently code transactions for a specific vendor to a specific expense account. Use the following report to quickly locate the exceptions and to determine if the exception is warranted or if the exception is due to an incorrectly coded transactions.

- Step 1. Create a Profit & Loss report for the period you are analyzing (e.g. the previous fiscal year).
- Step 2. Double-click Total Expense. QuickBooks creates a Transaction Detail report showing each post to operating expenses.
- Step 3. Add and remove columns on the report until only the following columns show:
 - a. Type
 - b. Date
 - c. Source Name
 - d. Memo
 - e. Account
 - f. Debit
 - g. Credit
 - h. Balance
- Step 4. Total the report by Vendor. Then, review each vendor grouping to locate any irregular postings for a specific vendor. Double-click and edit the transactions as necessary.
- Step 5. At the bottom of the report you will probably see a grouping for "No Name." This group shows all of the posts to operating expense that were not associated with a vendor name. The most common posts should be payroll expenses (which are associated with employee names) and interest expense (which clients often record on the bank reconciliation window where there is no ability to add a vendor name). Review all other posts (e.g. journal entries and checks without payees) to make sure the client posted to expenses accurately on these transactions.

Tip: If the client does not use inventory items and the Profit & Loss shows amounts for Cost of Goods Sold, repeat the steps above by double-clicking Total COGS on the Profit & Loss.