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ECOMMERCE FINANCIAL SOLUTIONS

Inventory Basics—What Every Ecommerce Seller Needs to Know

This is what you need to know in everyday language so you can handle the bookkeeping correctly for your ecommerce business. We will tackle this complicated subject by breaking it down into these six areas:

1. How inventory works on the Balance Sheet and the P&L
2. What needs to be included in unit cost calculations
3. What should be expensed directly to the P&L
4. Best practices for tracking inventory on a spreadsheet
5. Considerations for using an inventory software tool
6. Advanced Inventory Issues

How Inventory Works on the Balance Sheet and Profit and Loss Statement

Recognizing Inventory

First, let's get really clear on what Inventory is. It is an Asset. When I teach our program, "Know Your Numbers" I tell my students, it's like Cash you can't spend. You have traded your cash for something you think you can sell for more cash. If you look at your financial statements, you'll find your bank accounts (Cash) on your Balance Sheet and just below the Bank Accounts, you will see Inventory. This is because the Balance Sheet is where you track Assets (what you own) and Liabilities (what you owe) and Owner's Equity (the value of your ownership stake in the business).

The Profit and Loss Statement (P&L) is the report that allows you to look at your profitability for the current month, quarter, or year. At the end of the year, your net income (or loss) will transfer over to the Owner's Equity section of the Balance Sheet where the accounting picture is tracked from the beginning of your business.

In the simplest terms, Inventory on the Balance Sheet is owned by you and has not yet been sold to your customer. Once you sell it, it shows up on the Profit and Loss as a Cost of Goods Sold (COGS).

Purchasing Inventory

The first transaction that will add inventory on your books is the purchase of inventory from either 1) your manufacturer, if you have a private label business model; 2) your supplier, if you have a wholesale model; or 3) from a retail outlet, if you have a retail or online arbitrage model. When you purchase the goods, cash will leave your bank and you take possession of the inventory. From an accounting perspective, you will credit (decrease) your cash bank account and debit (increase) inventory in the books. This is the simplest, most straight forward activity.

In reality, many businesses pay with a credit card. In that case, you will credit the credit card liability account, increasing its balance and debit your inventory account, also increasing its balance. When you pay your credit card bill, you will debit the credit card account, reducing its balance—meaning you owe less; and you will credit cash, meaning your cash balance goes down both at your bank and in your books. Oftentimes, private label and wholesale businesses must make a down payment towards their inventory purchase and must deal with paying for goods that take weeks of shipping to actually have the physical inventory available for sale. I cover those situations in the Advanced section of this guide.

Dropshipping

Dropshipping is a unique scenario where you buy a product because you have made a sale. The transaction takes place in a short span of time. In this case, you record the purchase of the item directly as a Cost of Goods Sold on the P&L because you never carry the item as Inventory. The purchase of the product never hits the Balance Sheet.

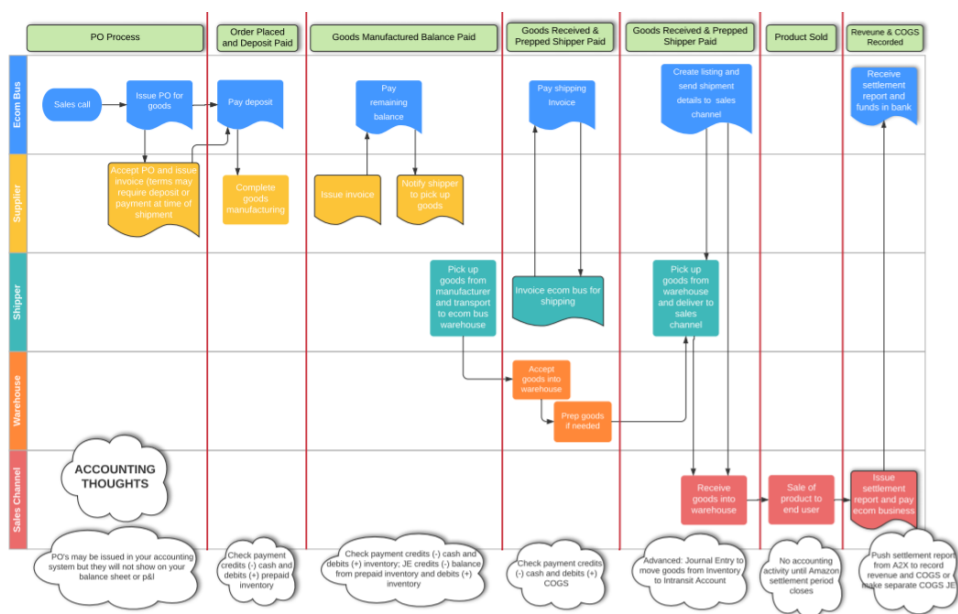
Consuming Inventory

To truly understand your profitability, you will move your inventory onto your Profit and Loss Statement when you no longer own it. The act of selling your product on Amazon, Shopify, etc. is the event that triggers the move out of the inventory bucket on the Balance Sheet and onto the P&L as a Cost of Goods Sold. There are actually a few key aspects of this transaction that you need to consider.

- 1. When do you move from Inventory to Cost of Goods Sold?** You want to make this shift match the timing of your revenue received. If you sell an item for \$100 in May, you will move the cost of that product from inventory (say \$30) and add it to your COGS account in May.
- 2. Watch the timing of your sale based on your settlement.** You may make the sale in May on Amazon, but not record the revenue until June when you received your Amazon Payout. You want to ensure you're matching the monthly recording of the Cost of Goods Sold with the month when you record your revenue. If you mix the months, your ability to understand profitability is compromised.
- 3. The value that you remove from inventory is based on your cost per unit.** You will consider all the direct costs of each product multiplied by the number of units sold. Make this calculation for every product and add them together. This is the number you will need to enter into your accounting system to reduce inventory and add to the Cost of Goods Sold.
- 4. The actual transaction that you will use in your accounting system is a journal entry.** You will reduce your inventory by crediting the Inventory Account and increase your Cost of Goods Sold by debiting that account.

Basic Inventory Flow Chart with A2X-Amazon Accounting Process

[Click here](#) to view bigger image.



What Needs to be Included in Unit Cost Calculations?

Developing the unit cost for a product is something you will do periodically as prices for your goods change. Develop a methodology, perhaps on a spreadsheet, where you can easily update the calculations when your costs factors change. To help you develop your costs, here are some typical unit costs to consider for your calculation:

- Actual cost of the product based on what you pay your manufacturer per unit
- Cost of packaging, boxes, bags, etc.
- Labor for your team that assembles and packs the boxes

Often clients want to include the freight and custom fees from their manufacturer to Amazon, or their 3PL. This is called Inbound Shipping and while it can be inventoried, we advise against this for a couple of reasons:

- The cost of shipping varies greatly depending on the method of shipment, air vs. sea vs. truck, plus constant variations in the cost of fuel.
- There is an extensive effort required to properly and accurately load the costs into your inventory and then adjust these costs as shipping costs change. It's generally not worth the effort unless you are using a sophisticated inventory management software and/or freight is a high percentage of total cost.

Because of the above considerations, we recommend that inbound freight or shipping be recognized as a period expense directly from an account on your P&L called Inbound Shipping. This account will appear in a section of the P&L where you capture direct costs.

What Should be Expensed Directly to the P&L?

On your P&L, the Direct Costs section is called Cost of Goods Sold in the QuickBooks Online system, or Cost of Sales in the Xero accounting system. This may be confusing at first because you also have a Cost of Goods account used in both systems for recording the cost of the products sold. For that reason, I'm going to use the term Direct Costs to refer to the middle section of the P&L. This section of the P&L or group of accounts allows you to record other items such as shipping that are not being added to your inventoried product costs. The Direct Cost section of your P&L is helpful to ensure you get an accurate picture of your profitability at the gross margin level before operating expenses are deducted.

Inbound shipping is typically expensed to the Direct Cost section of the P&L. We typically record the payment for shipping in the month where the bill was paid. It will cause a hit to your profitability, but it is easily identified because it is in its own account.

There are other expenses that are not inventoried. Finished goods warehousing, license fees, and paid sales commissions are examples. These are not "inventoriable" costs, because they don't "attach" to the product during the production process. You typically pay these expenses as you're invoiced. You do incur these expenses as a direct result of product sales (hence "direct cost") and, therefore, they should not be counted as operating expenses.

Be very careful to be consistent in your approach. If you include shipping in your unit cost calculation, then you must pay for shipping out of your inventory account. If you were to include it in your product costs and also charge it to an Inbound Shipping account on your P&L, you would be adding the costs twice on your P&L. After a few months, you would start to see that the numbers were not making sense. So, a rule of thumb is whatever you add into your unit cost numbers, be sure you are also capturing them in the inventory account.

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What Are Best Practices for Tracking Inventory on a Spreadsheet?

Spreadsheets are a great tool for new sellers as they start to understand their needs for tracking inventory. If you only have a few SKUs (stock keeping units), you can rely on spreadsheets for some time. You may also find that you need different spreadsheets for different purposes. For example, if you have calculated your unit costs, to calculate your inventory on hand, you would download from Amazon the inventory quantity in Seller Central and then use a VLOOKUP function to match the count of each SKU to the unit costs in your table. This is done quite simply and is a great place to start as you develop your new inventory levels each month.

As you can see, when you first get started, you can do quite a lot with spreadsheets before you reach the point where you need software to help you manage.

Using an Inventory Software Tool

As your inventory gets more complex and sophisticated, you may want to consider a software tool. There are several products available that offer a snapshot into your profitability and also assist with listing your products on Amazon. Many of our clients use Inventory Lab when they first start selling on Amazon. There are also many other inventory tools in the market. Here are a few we see frequently: Seller Legend, CIN7, Dear Systems, SOS Inventory, Locate, Unleased, Manage by Stats. These programs provide a lot of useful information, but they are not accounting systems. Many of them do produce a Profit and Loss Statement but they do not produce a Balance Sheet. For this reason, we recommend that you have a separate accounting system. Accounting systems should always reconcile back to external financial statements like bank and credit card statements. Accounting systems will always generate a Balance Sheet report. Should you ever decide to sell your business, you will need to have both a P&L and Balance Sheet for the due diligence audits.

There are many features available with inventory systems. You may not need all of these, but some of the features to consider are:

- What channels do they integrate with and are they channels you currently sell on or plan to sell on in the future?
- Do they track inventory in multiple warehouses?
- Do they integrate with your shipping services or 3rd Party Logistics?
- How do they handle refunds?
- How do they integrate with your accounting software for purchase orders and invoices?
- Do they generate purchase orders?
- Do they work with partial order fulfillment?
- How do they handle back orders?
- Do they handle forecasting future orders?
- Do you need manufacturing? Or Assemblies?
- Do they post by batch or transactional?
- What type of support do they offer—live chat? Phone?

While this may seem like a lot, narrow it down by thinking through what you need now and what you expect to need in the future. Make a list based on what you must have and what would be nice to have and then rank them so that you get the order of importance. Then as you evaluate each system, you can determine how closely they fit your needs.

Many people are concerned about having their inventory system integrate with their accounting software. We recommend that you keep these two systems separate. If you think about it, your inventory system is handled by your warehouse employees as they manage orders. If this is linked tightly with your financial software, QuickBooks Online, Xero, etc., then an error in your warehouse can create an error in your financial system.

Truly, they are serving different purposes and there is primarily one entry to be made from the inventory system into the accounting system. You simply need to pull your Cost of Goods Sold value for the time period and make the journal entry I described in the first section of this guide. The hassles of integration and keeping the two systems in sync take much more time than this simple journal entry.

Advanced Inventory Issues

Quarterly Inventory True up

If you do a journal entry every month based on just the cost of the units sold, your inventory might still be off from time to time. This happens for many reasons. First, you may have damaged, stolen or lost inventory and you need to remove it from your books by writing it off. You may also have items that have expired, and you decide to donate them. No matter the circumstance that creates this issue, you want to periodically look at the actual value of what you have on hand. In some cases, a physical count of what is in your possession is a useful exercise.

To create this true up, you will count what is on-hand in your warehouse and download the count from Amazon and then apply the unit costs to each SKU. The total of these values is the value you should have on your books for inventory. Compare your calculated number to the value of the Inventory Account on the Balance Sheet and you can see how close you are. Remember that timing matters. So just after you've recorded your COGS entry is a great time to make the count. If you find that you are off, you will want to book a true-up entry for the difference to your Inventory Account to get the value of your physical count to match your books. The other side of the entry is Cost of Goods Sold (COGS), though you may want a separate COGS account just for true-ups – e.g.: “Inventory Adjustment.”

Prepaid Items and Items In-Transit

When you calculate your true-up entry, if you find that you are off quite a bit, you should look at two areas: prepaid items and items in transit. These are areas where you have dollars hitting your books, but the items may not be in your possession to count in your physical inventory.

An example of a prepaid item is where you have paid a down payment to your manufacturer. In this situation the money has left your business, you have paid for them partially but there is nothing to count. An example of in-transit would be for items for which you have paid the entire balance and the products are on a ship for 60 days, or where you sent them to Amazon at the end of the month, but they have not been accepted in at the time of your month-end inventory/Cost of Goods Sold entry.

If your direct costs do not appear to make sense comparing them month by month with your sales, many times these issues can be at play. By doing the true-ups, they work themselves out typically in a quarter, but if you want to get more sophisticated in your accounting you can create additional asset accounts on your balance sheet to hold these costs until the products are in your possession and the counts will match.

Profit First

We've covered a lot of what happens operationally and how it impacts your accounting for your products. However, that issue is minor compared to the havoc that paying for inventory can play on your cash flow. For this reason, I recommend that you create a bank account for the purpose of setting aside money from each sale in an account to use for paying for the next round of inventory. Too often clients use one bank account for operating expenses and inventory and as a result, they never appreciate the difference in cash flow patterns. The major downside is they never realize the money they are spending on operating expenses will cause them to be short when they have to pay for their next batch of inventory.

This problem can be easily solved by looking at the COGS entry you make in your accounting system associated with each Amazon payout. Then, transfer that amount of money into a separate bank account that you call Inventory, which is created for the purpose of keeping that money separated so its purpose is easily identified. When you pay for inventory, you pay it out of this account.

If you use credit cards to pay for inventory, then get a separate card to use for that purpose. Keep your operating expenses on your current card and use the new card to pay for inventory. When you pay off your inventory credit card, use the funds from the inventory bank account. You may want to grow your inventory, so just replenishing the bank account is not setting you up for growth. To solve this issue, you can calculate the replenishment amount and then add five percent more money or 10 percent if you can afford that much. The point is you separate it so that it doesn't just get consumed by operating expenses.

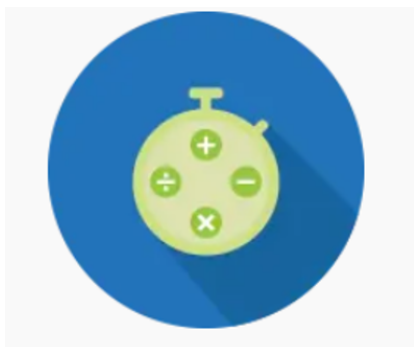
Summary

Inventory is vital to every ecommerce business. Understanding how inventory is treated from an accounting perspective is crucial for ecommerce business owners so you can understand your profitability. It's not enough to sell; you must make an adequate profit to ensure your business can pay you and continue to grow. After all, you created this business to support you, not the other way around!

Interested in Profit First?

If your ecommerce business isn't where you'd like it to be in terms of profitability, check out my book, [Profit First for Ecommerce Sellers](#).

It answers important questions about how to implement Profit First in an ecommerce business. Take control of your money and your business, and put Profit First to work for you!



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