Tips and Tricks #54 - More on The Internal Magic of Creating Purchase Orders from OE Orders (continued)

In the last segment, we started our deep dive into what costing considerations and what GL accounts are used in the Order Entry and PO functions. Here we complete the details.

Following are the differences between the Auto creation of PO's and Drop-ships generated from OE and "normal" independent PO's and OE Orders:

The PO Part

Even though the PO can be automatically created out of the OE Order, the PO that is generated is essentially "normal" i.e. one where the material is processed and costed in close to a standard fashion.

There are, as we have seen in the prior installments, several differences in the auto generated PO's from the true "normal" PO's. Obviously, this includes a number of fields that are automatically generated into the PO by the OE Order and the fact that the destination of the shipped goods becomes your customer's delivery location. There are also certain limitations with how the PO order can be used and updated since it is closely tied to the OE Order. Despite this, we can consider these differences "incidental" to the accounting distribution from the fact that generating the PO document does not affect these.

The most significant difference lies in the PO Receiving of items corresponding to an OE drop-ship order. Fundamental to this is that goods shipped from PO's created from these OE Orders, are not destined to go into your inventory but rather go directly from your vendor to your customer.

However, we do have to do a receiving on these PO's because we must acknowledge that the PO has been satisfied and that "x" amount of inventory was delivered by the vendor to your customer and at a cost of "y" dollars. This acknowledgement will allow us to close the PO. To do this while avoiding updating the inventory, when we create the PO line, we need to mark any of these Order Entry drop-ship line items as non-inventory i.e. instead of the received line item being a type "I" (inventory) line which would be received into "Inventory", these drop-ship lines will be entered as a type "O" item and received to "other" (i.e. non-inventory). Actually, these drop-shipped lines out of OE will be marked as a "D" to differentiate them from regular non-drop shipped "O" s; but will be processed like "O" s.

Whether the "O" or "D" type, generally, this "O" type of receiving acknowledges that dollars were spent on the items without putting them into stock. These kinds of items can be either things like office expenses or drop ships. To be clear, the receipt of a valued item (goods or services) is acknowledged in all cases, but it is just that in the case of "Other" the ordered items are not directed to your inventory. The received items could be going to a supplies cabinet if the PO vendor was to an office supplier, to a ground's maintenance vendor for a year's contract on outside maintenance or, in the case of our special OE orders, a drop ship to the client.

The PO Receiving posting will reflect these transactions by posting a credit for the received value to the previously mentioned Uninvoiced Receivings (UIR) account. However, instead of debiting the inventory as it normally would do (cf. above), it will debit the Drop Ship Clear account (see below).

The OE Part

Keep in mind that the OE Order/Customer invoice will typically be posted before the drop-ship items are shipped by the vendor to the customer, and likely even before you get an invoice for these goods from the vendor. The important result here is that, as a result of these timings, the cost of sale (CoS) will be coming from a “best guess” typically based on the Average Cost of your current inventory. This cost is a “guess” or estimate because the specific inventory being shipped from the vendor to the customer could conceivably have different unit costs from the unit costs that are currently in your inventory and may even be different from the costs posted when you printed and posted the Purchase Order document.

Controlling this potential issue of a difference between ordered and received is fundamentally a matter of using the PO to allow you to be as sure as possible that the expected quantities are delivered at the expected unit costs. This is why a negotiated price is included in the OE portion of this cycle so you can specify an agreed upon cost ahead of time. Nevertheless, things can happen …

As a result, the vendor invoice for these POs’ which is the ultimate confirmation of the costs of these drop-shipped items may not be received until well after you have posted the OE invoice for the items that the PO represents. In other words, you will have had to post the cost of sales distributions for these sales before you have the actual costs. This why the CoS in this case is potentially an estimate – maybe a good guess based on a history of stable costs or the negotiated cost, but, until the vendor invoice is delivered to you, an estimate, nonetheless. This should be considered while reviewing the costs that are generated into your Cost of Sales account from drop-ship orders and may require adjustment of Cost of Sales through, for example, a transfer from a Cost Price Adjustment account to CoS.

Distributions – one more accrual account and its relation to Cost of Sales

In posting a regular, normal invoice and shipment out of OE, the OE posting program will Credit (reduce) Inventory value by the cost of the items being shipped and will Debit the Cost of Sales (CoS) account (specified in the setup of the order) by the same amount. In the drop-ship cycle, the OE program posts what would have been the credit to inventory value instead to the Drop Ship Clearing Account (DSC) and in this case the DSC is the offset to the CoS account just as Inventory is the offset to CoS in a normal invoice. (The DSC GL account number is defined in the OE Control file on Tab 2).

This DSC clearing/accrual account corresponds to the holding account for either the Credit to the DSC account from the OE Invoice posting or, the Debit to the DSC account from the PO Receiving posting (see above). This also means, theoretically, for any completed PO Receiving/OE Dropship cycle the net of these two should be zero i.e. the debit out of the PO posting should match the credit out of the OE posting.

This is “theoretical” because of the asynchrony between when the various PO Receivings are posted and when the OE Invoices are posted. As a result, a reconcilable residual should remain at the end of each month which corresponds to PO Receivings not yet posted in OE or vice versa. Although typically the OE posting will come first, it doesn't really matter as long as one clears the other.

Note that because both the two accrual/clearing accounts (UIR, DSC) that we have discussed here should net to zero for each completed transaction cycle, but as described above, will not normally be in zero balance over all transactions. Reviewing these accounts at month end corresponds to another monthly reconciliation task to monitor that the flow of data is correct.

Drop ships - a final step – the AP voucher for the Vendor Invoice

The last consideration is what happens in AP with vouchering the vendor invoice for these PO's we have generated. Normally for vouchering a PO that has been received to inventory, we would do the AP "expense" side distribution to the UIR account. Recall that the UIR account received a Credit for the received value when we posted the Receiving. Here we clear that value while updating the AP account which is its offset.

As we have seen for the OE Drop ship generated PO's, the same process is used. In other words, the Receiving will have credited the UIR account for the value of the non-inventory and so to clear this account the voucher distribution should debit that account.

In normal use, the program will always, automatically credit the AP account assigned to a vendor and the vouchering process will also use a default GL account setup for each vendor, for the "expense" side account as well; but this can be overridden. The implication here is that when a vendor relation is established that uses PO's to order the material or labor the UIR account should be setup as the default "expense" account for that vendor. This is the "Default dist acct no." account stored in the third tab for each vendor in the Vendor Master.

Summary

1. OE Invoices create drop ship line items which, when posting costs, will credit the DSC account and debit CoS.

2. An auto created PO generated from the OE Order will be of the non-Inventory ("Other") type – that will mean a receiving will not update (local) Inventory. As a result, the received value will debit the DSC account (which replaces the Inventory account for (local) warehouse Receivings). A credit to the UIR account will be its offset.

3. The net effect of 1) and 2) will be a net zero in the DSC.

4. In a similar fashion when the vendor invoices from the PO's are processed, the debit to the expense account will be the UIR with the offset being AP.

5. The net effect of 2) and 4) will be a net zero in the UIR.

6. Doing a logical sum over steps 1), 2), 4), we end up with a zero in all accounts except a credit to AP and a debit to CoS which is exactly as you would expect: - the Cost of Sales recorded by the sale equals the cost of the goods purchased (AP) to make that sale.

7. The vendors who are normally being called upon for inventory items, should be set up with the UIR as their default expense account in the AP Master record for that item. This applies whether the purchases are actually being received or being drop-shipped. Even

the vendor’s default cost/expense account will be defaulted to the UIR if set up this way, it can be overridden and change to an expense account if a purchase will not go to inventory or sales and is considered a direct business expense.

8. The DSC account replaces the GL Inventory account whenever drop-shipped OE Order or PO’s are being processed.