chAPTER 4

accounting for Merchandising operations

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| Chapter Outline |
| **I. Merchandising Activities** |
| A. Merchandise refers to products, also called goods, which a company buys to resell. Merchandisers can be either wholesalers (those that buy from manufacturers and sell to retailers) or retailers (those that buy from manufacturers or wholesalers and sell to consumers). B. Reporting Income for a MerchandiserRevenue from selling merchandise (*net sales*) minus the *cost of goods sold* to customers is called *gross profit*. Gross profit minus *operating expenses* determines the net income or loss for the period. C. Reporting Inventory for a MerchandiserA merchandiser’s balance sheet is the same as a service business with the exception of one additional *current* asset called: |
| 1*. Merchandise inventory,* or *Inventory*, refers to products that a company owns and intends to sell.2. The cost of this asset includes the cost incurred to buy the goods, ship them to the store, and make them ready for sale. |
| D. Operating Cycle for a MerchandiserBegins with purchasing merchandise for cash and ends with collecting cash from selling the merchandise.E. Inventory SystemsTwo alternative inventory systems that can be used to collect information about the cost of goods sold and the inventory (cost of goods available) are: |
| 1*.* *Perpetual inventory system*—updates accounting records for *each* purchase and *each* sale of inventory. Technological advances and competitive pressures have drastically increased the use of this method.2. *Periodic inventory system*—updates the accounting records for purchases and sales of inventory *only at the* *end of a period*.**Note: This outline describes the accounting using a Perpetual Inventory System. Periodic Inventory is discussed in the Appendix 5A section of this outline. Also note, the terms *inventory* and *merchandise inventory* are synonymous. Inventory is used for brevity.** |
| **II. Merchandise Purchases**The *invoice* serves as a *source document* for the event. |
| A. Purchases without Cash Discounts.1. Entry to record purchase—debit Inventory, credit Cash or Accounts Payable. |
| 2. Trade Discounts—deductions from list price (catalog price) to determine the invoice price (actual selling price). Trade discounts are not entered into accounts.  |
| B. Purchase with Cash Discounts1. *Credit Terms* describe cash discounts offered to purchasers by the seller for payment within a specified period of time called the *discount period*.
2. *Cash Discounts*—granted by the seller to encourage buyers to pay the amount they owe earlier. Buyers view cash discounts as purchase discounts and sellers view them as sales discounts.
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| 1. Example: *credit terms*, 2/10 n/30, offer a 2% discount if invoice is paid within 10 days of invoice date; if not, full payment is due within 30 days of invoice date.
2. Purchases on Credit—entry for buyer for purchase using full invoice, gross method is: debit Merchandise Inventory and credit Accounts payable.
3. Payment within Discount Period—debit Accounts Payable (full invoice amount), credit Cash (full invoice – discount), credit Inventory (amount of discount).
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| 1. Managing Discounts—Missing out on cash discounts can be very costly. A system should be set up to ensure that all invoices are paid on the last day of discount period.
2. Payment after Discount Period—debit Accounts Payable and credit Cash.

C. Purchases with Returns and Allowances |
| 1. *Purchases allowances* refers to a reduction in the cost of defective merchandise that a buyer acquires.2. *Purchases returns* are merchandise a buyer acquires but then returns to the seller.3. A *debit memorandum* informs the seller of a debit made to the seller’s account payable in the buyer’s records.4. Entry on buyer’s books—debit Accounts Payable or Cash (if refund given) and credit Inventory. |
| 5. Discounts can only be taken on the remaining balance on the invoice if a return is made before payment is made.D. Purchases and Transportation Costs—the point at which ownership is transferred (called FOB or *free on board*). Two alternative points of title transfer are: |
| 1. FOB shipping point—title transfers at shipping point and buyer pays shipping costs.  |
| a. Increases cost of merchandise (cost principle)b. Debit Inventory, credit Cash or Accounts Payable (if to be paid for with merchandise later) |
| 2. FOB destination—title transfers at destination and seller pays shipping costs. |
| a. Operating expense for sellerb. Debit Delivery Expense and credit Cash |
| E. Itemized Costs of Purchases—the net cost of purchased merchandise according to the *cost principle* is recorded in the Inventory account. Inventory is debited (increased) for invoice and transportation costs, and credited (decreased) for returns, allowances, and purchase discounts. *Supplemental records* are often used to collect information about each of these cost elements for management to evaluate and control.  |
| **III. Merchandise Sales—**involves sales, sales discount, sales returns and allowances, and cost of goods sold |
| A. Each sale of merchandise transaction involves two entries: the revenue entry and the cost entry. |
| 1. Revenue recorded —debit Accounts Receivable (or cash), credit Sales (both for the invoice amount).2. Cost of goods sold incurred —debit Cost of Goods Sold, credit Inventory (both for the cost of the inventory sold).B. Sales without Cash Discounts—Revenue side: Inflow of Assets. Debit Accounts Receivable (or Cash) and credit Sales. Cost side: Outflow of Assets: debit Cost of Goods Sold and credit Inventory. |
| C. Sales with Cash Discounts  1. Sales on Credit—revenue side using the gross method is a debit Accounts Receivable and a credit Sales. 2. Buyer Pays within Discount Period—debit Cash (invoice amount minus discount), debit Sales Discounts (discount amount), credit Accounts Receivable (full invoice amount).  |
| 3. Buyer Pays after discount period—debit Cash, Credit Accounts Receivable (full invoice amount).4. Sales Discounts is a contra revenue account—subtraction from Sales. |
|  Sales with Returns and Allowances |
| 5. *Sales returns—*merchandise that a customer returned to the seller after a sale. 6. *Sales allowances*—reductions in selling price of merchandise sold to customers (usually for damaged merchandise that a customer is willing to keep at a reduced price). |
| 7. Buyer Returns Goods—seller issues refund for returned goods. Entry: debit Sales Returns and Allowances and credit Cash; additional entry to restore cost of returned goods to inventory if merchandise is returned and it is salable: debit Inventory, credit Cost of Goods Sold.8. Seller receives returned goods into inventory—seller also reduces cost of sales.9. Returned goods not defective—if inventory can be resold, seller debits Inventory and credits Cost of Goods Sold.10. Returned goods are defective—debit Inventory for estimated value; debit Loss from Defective Merchandise (difference between cost and estimated value) and credit Cost of Goods Sold (for cost).11. Sales Returns and Allowances is a contra revenue account that is subtracted from Sales.12. Credit Memorandum—issued by the seller to inform buyer of a credit made to buyer’s Accounts Receivable in seller’s books.13. Buyer Granted Allowances—merchandise which is defective but buyer decides to keep, seller will record a debit to Sales Returns and Allowances and a credit to Cash for the reduction in price. If seller has not yet collected cash for goods sold, seller could credit buyer’s Accounts Receivable. |
| **IV. Adjusting and Closing for Merchandisers** |
| A. Adjusting Entries for MerchandisersGenerally same as discussed for a service business with an additional adjustment needed to update inventory to reflect any loss of inventory referred to as *shrinkage*. |
| 1. Shrinkage determined by comparing a physical count of the inventory with recorded quantities.2. Adjusting entry—debit Cost of Goods Sold, credit Inventory—Adjusting Entries. 3. Sales Discounts, Returns, and Allowances—Sales are to be reported at the net amount expected which follows new revenue recognition rules. Period-end adjusting entries are commonly made for: expected sales discounts; expected returns and allowances (revenue side) and expected returns and allowances (cost side). Appendix 4C explains these adjusting entries. |
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| C. Closing Entries for Merchandisers—similar to a service business, except there are additional temporary accounts to close including sales, sales discount, sales returns and allowances, and cost of goods sold. Debit balance accounts are closed with the expense accounts to Income Summary. |
| **V. More on Financial Statement Formats—**Common formats include multiple-step and single-step. |
| A. Multiple-Step Income Statement—details of net sales and expenses. Has three main parts: 1. *Gross profit*—net sales minus cost of goods sold.2. *Income from operations*—gross profit minus operating expenses (separated into selling and general & administrative).3*. Net income*—Income from operations plus or minus nonoperating items. B. Single-Step Income Statement—lists cost of goods sold as another expense and shows only one subtotal for total expenses. Expenses grouped into few, if any, categories. |
| C. Classified Balance Sheet—reports merchandise inventory as a current asset, usually after accounts receivable, according to how quickly they can be converted to cash.  |
| **VI. Decision Analysis—Acid-Test and Gross Margin Ratios** |
| A. Acid‑Test Ratio |
| 1. Used to assess the company’s liquidity or ability to pay its current liabilities. Differs from current ratio in that it is based on quick assets (which excludes less liquid current assets such as inventory and prepaid expenses) rather than all current assets.2. Calculated by dividing *quick assets* by current liabilities.3. Quick assets are cash, short-term investments, and current receivables. |
| B. Gross Margin Ratio (Gross Profit Ratio) |
| 1. Used to determine the percent of every sales dollar that is gross profit.2. Calculated by dividing gross margin by net sales. |
| **VII. Periodic Inventory System (Appendix 4A)—**textbook shows comparison of periodic and perpetual in this appendix. The following chapter notes relate only to the periodic system, because the preceding notes outline the perpetual system. |
| A. A periodic inventory system records merchandise acquisitions, discounts and returns in temporary accounts (Purchases, Purchase Returns, Purchases Discounts) rather than the merchandise inventory account.B. Records only the revenue aspect of sales related events. Updates inventory and determines cost of goods sold only at the end or the accounting period. During the period, inventory account remains unchanged.C. The inventory account can be updated as part of the adjusting or closing process.D. Requires closing additional temporary accounts.**VIII. Adjusting Entries under New Revenue Recognition Rules (Appendix 4B)**1. Expected Sales Discounts—Adjusting Entry: New revenue recognition rules require the reporting of sales at the net amount expected. Period-end adjusting entry needed to estimate sales discounts for current-period’s sales expected to be taken in future periods. Entry: debit Sales Discounts and credit Allowance for Sales Discounts.
2. Allowance for Sales Discounts is a contra asset account having a normal credit balance and is reported on the balance sheet as a reduction to Accounts Receivable.
3. Expected Returns and Allowances—Adjusting Entries: New revenue recognition rules require sellers to estimate sales returns and allowances in the period of sale.
4. Revenue Side for Expected R&A—seller credits Sales Refund Payable, current liability reflecting amount expected to be refunded to customers and debits Sales Returns and Allowances.
5. Sales Refund Payable is updated only during the adjusting entry process. Balance remains unchanged during the period.
6. Cost Side for Expected R&A—seller debits Inventory Returns Estimated, current asset reflecting inventory estimated to be returned, and credits Cost of Goods Sold.
7. Inventory Returns Estimated account is updated only during the adjusting entry process. Balance remains unchanged during period.

**VIX. Net Method for Merchandising (Appendix 4C)**Net method initially records the invoice at an amount net of any cash discount, so cash discounts are deducted from Inventory when initially recorded.1. Perpetual Inventory System Purchases—debit Inventory and credit Accounts Payable for the net amount.
2. If invoice paid within discount period, debit Accounts Payable and credit Cash for net amount.
3. If invoice paid after discount period, debit Accounts Payable for net amount, debit Discounts Lost (for amount of discount), and credit Cash for full invoice amount.
4. Perpetual Inventory System Sales—debit Accounts Receivable and credit Sales for the net amount. Also, debit Cost of Goods Sold and credit Inventory for cost.
5. If cash is received within the discount period, debit Cash and credit Accounts Receivable for the net amount.
6. If cash is not received within the discount period, debit Cash for full invoice amount, credit Accounts Receivable for net amount and credit Interest Revenue for amount of discount.
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