**PREVIEW OF CHAPTER 5**

**ACCOUNTING FOR MERCHANDISING OPERATIONS**

- Merchandising Operations
- Inventory systems
- Recording Purchases of Merchandise
- Purchase returns and allowances
- Freight costs
- Purchase discounts
- Recording Sales of Merchandise
- Sales returns and allowances
- Sales discounts
- Completing the Accounting Cycle
- Adjusting entries
- Closing entries
- Summary of entries
- Forms of Financial Statements
  - Multiple-step income statement
  - Single-step income statement
  - Classified balance sheet

---

**MERCHANDISING COMPANY**

A merchandising company buys and sells goods to earn a profit.

1) Wholesalers sell to retailers
2) Retailers sell to consumers

Primary source of revenue is Sales

---

**MEASURING NET INCOME**

- Expenses for a merchandiser are divided into two categories:
  1. Cost of goods sold
     - The total cost of merchandise sold during the period
  2. Operating expenses
     - Expenses incurred in the process of earning sales revenue
     (Examples: sales salaries and insurance expense)

- Gross profit is equal to Sales Revenue less Cost of Goods Sold

---

**INCOME MEASUREMENT PROCESS FOR A MERCHANDISING COMPANY**
OPERATING CYCLES FOR A SERVICE COMPANY AND A MERCHANDISING COMPANY

INVENTORY SYSTEMS

Merchandising entities may use either:
1) Perpetual Inventory
   Detailed records of the cost of each item are maintained, and the cost of each item sold is determined from records when the sale occurs.
2) Periodic Inventory
   Cost of goods sold is determined only at the end of an accounting period.

COST OF GOODS SOLD

To determine the cost of goods sold under a periodic inventory system:
1) Determine the cost of goods on hand at the beginning of the accounting period,
2) Add to it the cost of goods purchased, and
3) Subtract the cost of goods on hand at the end of the accounting period.

PURCHASES OF MERCHANDISE

- Merchandise is purchased for resale to customers, the account
- Merchandise Inventory is debited for the cost of goods.
- Like sales, purchases may be made for cash or on account (credit).
- The purchase is normally recorded by the purchaser when the goods are received from the seller.
- Each credit purchase should be supported by a purchase invoice.
PURCHASES OF MERCHANDISE

SALES INVOICE

For purchases on account, Merchandise Inventory is debited and Accounts Payable is credited.

PURCHASE RETURNS AND ALLOWANCES

- A purchaser may be dissatisfied with merchandise received because the goods:
  1) are damaged or defective,
  2) of inferior quality, or
  3) not in accord with the purchaser’s specifications.
- The purchaser initiates the request for a reduction of the balance due through the issuance of a debit memorandum (purchaser’s debit decreases A/P!).
- The debit memorandum is a document issued by a buyer to inform a seller that the seller’s account has been debited because of unsatisfactory merchandise.

ACCOUNTING FOR FREIGHT COSTS

- Merchandise Inventory is debited if buyer pays freight.
- Freight-out (or Delivery Expense) is debited if seller pays freight.

FREE ON BOARD

A sales agreement should indicate whether the seller or the buyer is to pay the cost of transporting the goods to the buyer’s place of business.

- FOB Shipping Point
  1) Goods placed free on board the carrier by seller
  2) Buyer pays freight costs
- FOB Destination
  1) Goods placed free on board at buyer’s business
  2) Seller pays freight costs

PURCHASES OF MERCHANDISE

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 4</td>
<td>Merchandise Inventory Accounts Payable (To record goods purchased on account, terms 2/10, n/30, from Sellers Electronix)</td>
<td>3,800</td>
<td>3,800</td>
</tr>
</tbody>
</table>

For purchases on account, Merchandise Inventory is debited and Accounts Payable is credited.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 8</td>
<td>Accounts Payable Merchandise Inventory (To record return of inoperable goods received from Sellers Electronix, DM No. 126)</td>
<td>.300</td>
<td>.300</td>
</tr>
</tbody>
</table>

For purchases returns and allowances, Accounts Payable is debited and Merchandise Inventory is credited.
ACCOUNTING FOR FREIGHT COSTS

When the purchaser directly incurs the freight costs, the account Merchandise Inventory is debited and Cash is credited.

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 6</td>
<td>Merchandise Inventory</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(To record payment of freight, terms FOB shipping point)

Freight costs incurred by the seller on outgoing merchandise are debited to Freight-out (or Delivery Expense) and Cash is credited.

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 4</td>
<td>Freight-out (Delivery Expense)</td>
<td>150</td>
<td>150</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(To record payment of freight on goods sold FOB destination)

PURCHASE DISCOUNTS

• Credit terms may permit the buyer to claim a cash discount for the prompt payment of a balance due.

• The buyer calls this discount a purchase discount.

• Like a sales discount, a purchase discount is based on the invoice cost less returns and allowances, if any.

If payment is made within the discount period, Accounts Payable is debited, Cash is credited, and Merchandise inventory is credited for the discount taken.

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 14</td>
<td>Accounts Payable</td>
<td>3,500</td>
<td>3,430</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td>70</td>
</tr>
<tr>
<td></td>
<td>Merchandise Inventory</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(To record payment within discount period)

If payment is made after the discount period, Accounts Payable is debited and Cash is credited for the full amount.

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 3</td>
<td>Accounts Payable</td>
<td>3,500</td>
<td>3,500</td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(To record payment with no discount taken)

SAVINGS OBTAINED BY TAKING PURCHASE DISCOUNT

A buyer should usually take all available discounts. If Beyer Video takes the discount, it pays $70 less in cash. If it forgoes the discount and invests the $3,500 for 20 days at 10% interest, it will earn only $19.06 in interest. The savings obtained by taking the discount is calculated as follows:

Discount of 2% on $3,500 $ 70.00
Interest received on $3,430 (for 20 days at 10%) ( 19.06)
Savings by taking the discount $ 50.94
SALES TRANSACTIONS

STUDY OBJECTIVE 3

• Revenues – (Revenue recognition principle)
  – Earned when the goods are transferred from seller to buyer

• All sales should be supported by a document such as a cash register tape or sales invoice.

RECORDING CASH SALES

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 4</td>
<td>Cash Sales (To record daily cash sales)</td>
<td>2,200</td>
<td>2,200</td>
</tr>
<tr>
<td></td>
<td>Cost of Goods Sold Merchandise Inventory (To record cost of merchandise sold for cash)</td>
<td>1,400</td>
<td>1,400</td>
</tr>
</tbody>
</table>

• For cash sales, Cash is debited and Sales is credited.
• For the cost of goods sold for cash, Cost of Goods Sold is debited and Merchandise Inventory is credited.

RECORDING CREDIT SALES

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 4</td>
<td>Accounts Receivable Sales (To record credit sales to Beyer Video per invoice #731)</td>
<td>3,800</td>
<td>3,800</td>
</tr>
<tr>
<td></td>
<td>Cost of Goods Sold Merchandise Inventory (To record cost of merchandise sold on invoice #731 to Beyer Video)</td>
<td>2,400</td>
<td>2,400</td>
</tr>
</tbody>
</table>

• For credit sales, Accounts Receivable is debited and Sales is credited.
• For the cost of goods sold on account, Cost of Goods Sold is debited and Merchandise Inventory is credited.

SALES RETURNS AND ALLOWANCES

• Sales Returns
  – Customers dissatisfied with merchandise and are allowed to return the goods to the seller for credit or a refund.

• Sales Allowances
  – Result when customers are dissatisfied and the seller allows a deduction from the selling price.

SALES RETURNS AND ALLOWANCES

• Credit memorandum
  – the seller prepares a form to inform the customer that a credit has been made to the customer’s account receivable

• Sales Returns and Allowances
  – Contra revenue account to the Sales account

• The normal balance of Sales Returns and Allowances is a debit

RECORDING SALES RETURNS AND ALLOWANCES

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 8</td>
<td>Sales Returns and Allowances (To record return of inoperable goods delivered to Beyer Video, per credit memorandum)</td>
<td>500</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>Merchandise Inventory Cost of Goods Sold (To record cost of goods returned per credit memorandum)</td>
<td>140</td>
<td>140</td>
</tr>
</tbody>
</table>

The seller’s entry to record a credit memorandum involves a debit to the Sales Returns and Allowances account and a credit to Accounts Receivable. The entry to record the cost of the returned goods involves a debit to Merchandise Inventory and a credit to Cost Goods Sold.
SALES DISCOUNTS

• Sales discount
  – Offer of a cash discount to a customer for the prompt payment of a balance due
  – Is a contra revenue account with a normal debit balance

• Example: Credit sale has the terms 3/10, n/30, a 3% discount is allowed if payment is made within 10 days. After 10 days there is no discount, and the balance is due in 30 days.

CREDIT TERMS

Credit terms specify the amount and time period for the cash discount
  – Indicates the length of time in which the purchaser is expected to pay the full invoice price

<table>
<thead>
<tr>
<th>TERMS</th>
<th>EXPLANATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/10, n/30</td>
<td>A 2% discount may be taken if payment is made within 10 days of the invoice date.</td>
</tr>
<tr>
<td>1/10 EOM</td>
<td>A 1% discount is available if payment is made by the 10th of the next month.</td>
</tr>
</tbody>
</table>

RECORDING SALES DISCOUNTS

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Dr.</th>
<th>Cr.</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 14</td>
<td>Cash</td>
<td>3,430</td>
<td>70</td>
</tr>
<tr>
<td></td>
<td>Sales Discounts</td>
<td>3,500</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts Receivable (To record collection within 2/10, n/30 discount period from Beyer Video)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

When cash discounts are taken by customers, the seller debits Sales Discounts.

CLOSING ENTRIES

STUDY OBJECTIVE 4

• Adjusting entries are journalized from the adjustment columns of the work sheet.
• All accounts that affect the determination of net income are closed to Income Summary.
• Data for the preparation of closing entries may be obtained from the income statement columns of the work sheet.

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Sales</td>
<td>480,000</td>
<td>480,000</td>
</tr>
<tr>
<td></td>
<td>Income Summary (To close income statement accounts with credit balances)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CLOSING ENTRIES

Cost of Goods Sold is a new account that must be closed to Income Summary.

GENERAL JOURNAL

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles and Explanation</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec. 31</td>
<td>Income Summary (To close net income to capital)</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td></td>
<td>R. A. Lamb, Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>R. A. Lamb, Drawing (To close drawings to capital)</td>
<td>15,000</td>
<td>15,000</td>
</tr>
</tbody>
</table>

After the closing entries are posted, all temporary accounts have zero balances
• It addition, R. A. Lamb, Capital has a credit balance of $98,000 ($83,000 + $30,000 - $15,000).
Under a perpetual inventory system, acquisition of merchandise for resale is debited to the

a. purchases account
b. supplies account
c. merchandise Inventory account
d. cost of Goods Sold account

MULTIPLE-STEP INCOME STATEMENT

• Includes sales revenue, cost of goods sold, and gross profit sections
• Additional nonoperating sections may be added for:
  1) revenues and expenses resulting from secondary or auxiliary operations
  2) gains and losses unrelated too operations

MULTIPLE-STEP INCOME STATEMENT

Operating expenses may be subdivided into:
  a) Selling expenses
  b) Administrative expenses

Nonoperating sections are reported after income from operations and are classified as:
  a) Other revenues and gains
  b) Other expenses and losses

SINGLE-STEP INCOME STATEMENT

SELLERS ELECTRONIX
Income Statement
For the Year Ended December 31, 2005

<table>
<thead>
<tr>
<th>Revenues</th>
<th>$ 460,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$ 460,000</td>
</tr>
<tr>
<td>Interest revenue</td>
<td>3,000</td>
</tr>
<tr>
<td>Gain on sale of equipment</td>
<td>600</td>
</tr>
<tr>
<td>Total revenues</td>
<td>465,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of goods sold</td>
<td>316,600</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>76,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>30,000</td>
</tr>
<tr>
<td>Interest expense</td>
<td>1,800</td>
</tr>
<tr>
<td>Casualty loss from vandalism</td>
<td>200</td>
</tr>
<tr>
<td>Total expenses</td>
<td>432,000</td>
</tr>
</tbody>
</table>

Net income $ 31,600

COMPUTATION OF GROSS PROFIT

Gross profit is determined as follows:

| Net sales         | $ 460,000 |
| Cost of goods sold| 316,000   |
| Gross profit      | $ 144,000 |
OPERATING EXPENSES IN COMPUTING NET INCOME

Net income is determined as follows:

<table>
<thead>
<tr>
<th>Gross profit</th>
<th>$144,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating expenses</td>
<td>114,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

Gross profit for a merchandiser is net sales minus:

a. operating expenses
b. cost of goods sold
c. sales discounts
d. cost of goods available for sale

REVIEW

Determining Cost of Goods Sold Periodic

<table>
<thead>
<tr>
<th><strong>Sellers Electronics</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cost of Goods Sold</strong></td>
</tr>
<tr>
<td>For the Year Ended December 31, 2005</td>
</tr>
<tr>
<td>Cost of goods available for sale</td>
</tr>
<tr>
<td>Cost of goods sold</td>
</tr>
<tr>
<td>Purchases</td>
</tr>
<tr>
<td>Less: Purchase returns and allowances</td>
</tr>
<tr>
<td>Net purchases</td>
</tr>
<tr>
<td>Add: Discounts</td>
</tr>
<tr>
<td>Discount Available</td>
</tr>
</tbody>
</table>

PERIODIC INVENTORY SYSTEMS

Appendix 5A

- Revenues from the sale of merchandise are recorded when sales are made in the same way as in a perpetual system
- No attempt is made on the date of sale to record the cost of merchandise sold
- Physical inventories are taken at end of period to determine:
  - The cost of merchandise on hand
  - The cost of the goods sold during the period

RECORDING MERCHANDISE TRANSACTIONS UNDER A PERIODIC INVENTORY SYSTEM

- Purchases
  - Merchandise purchased for resale to customers
  - May be made for cash or on account (credit)
  - Normally recorded by the purchaser when the goods are received from the seller
  - Credit purchase should be supported by a purchase invoice
RECORDING PURCHASES OF MERCHANDISE

To illustrate the recording of merchandise transactions under a periodic system, we will use the purchase/sale transactions between Seller and Buyer. For purchases on account, Purchases is debited and Accounts Payable is credited for merchandise ordered from Seller.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 4</td>
<td>Purchases</td>
<td>3,800</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Accounts Payable</td>
<td></td>
<td>3,800</td>
</tr>
</tbody>
</table>

PURCHASE RETURNS AND ALLOWANCES

- A sales return and allowance on the seller’s books is recorded as a purchase return and allowance on the books of the purchaser.
- Purchase Returns and Allowances
  - contra account to Purchases
  - Normal credit balance
- Debit memorandum
  - Purchaser initiates the request for a reduction of the balance due through the issuance of a debit memorandum
  - A document issued by a buyer to inform a seller that the seller’s account has been debited because of unsatisfactory merchandise

RECORDING PURCHASE RETURNS AND ALLOWANCES

For purchases returns and allowances, Accounts Payable is debited and Purchase Returns and Allowances is credited. Because $300 of merchandise received from Seller is inoperable, Buyer returns the goods and issues a debit memo.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 8</td>
<td>Accounts Payable</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Purchase Returns and Allowances</td>
<td>300</td>
<td></td>
</tr>
</tbody>
</table>

ACCOUNTING FOR FREIGHT COSTS

- Freight-in is debited if buyer pays freight
- Freight-out (or Delivery Expense) is debited if seller pays freight

ACCOUNTING FOR FREIGHT COSTS

When the purchaser directly incurs the freight costs, the account Freight-in (or Transportation-in) is debited and Cash is credited. In this example, Buyer pays Acme Freight Company $150 for freight charges on its purchase from Seller.

<table>
<thead>
<tr>
<th>Date</th>
<th>Account Titles</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 9</td>
<td>Freight-in</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cash</td>
<td>150</td>
<td></td>
</tr>
</tbody>
</table>

PURCHASE DISCOUNTS

- Credit terms may permit the buyer to claim a cash discount for the prompt payment of a balance due.
- The buyer calls this discount a purchase discount.
- Like a sales discount, a purchase discount is based on the invoice cost less returns and allowances, if any.
PURCHASE DISCOUNTS

If payment is made within the discount period, Accounts Payable is debited, Purchase Discounts is credited for the discount taken, and Cash is credited. On May 14 Buyer pays the balance due on account to Seller taking the 2% cash discount allowed by Seller for payment within 10 days.

RECORDING SALES OF MERCHANDISE

For credit sales, Accounts Receivable is debited and Sales is credited. In this illustration, the sale of $3,800 of merchandise to Buyer on May 4 is recorded by the Seller.

RECORDING SALES RETURNS AND ALLOWANCES

The seller’s entry to record a credit memorandum involves a debit to the Sales Returns and Allowances account and a credit to Accounts Receivable. Based on the debit memo received from Buyer on May 8 for returned goods, Seller records the $300 sales returns above.

RECORDING SALES DISCOUNTS

When cash discounts are taken by customers, the seller debits Sales Discounts. On May 15, Seller receives payment of $3,430 on account from Buyer. Seller honors the 2% discount and records the payment of Buyer’s accounts receivable.

WORK SHEET FOR A MERCHANDISING COMPANY

USING A WORK SHEET

Appendix 5B

Trial Balance Columns
1 Data from the trial balance are obtained from the ledger balances of Sellers Electronix at December 31
2 The amount shown for Merchandise Inventory, $40,500, is the year-end inventory amount which results from the application of a perpetual inventory system
### USING A WORK SHEET

**Adjustments Columns**

1. A merchandising company usually has the same types of adjustments as a service company.
2. Work sheet adjustments b, c, and d are for insurance, depreciation, and salaries.

**Adjusted Trial Balance** - The adjusted trial balance shows the balance of all accounts after adjustment at the end of the accounting period.

### USING A WORK SHEET

**Income Statement Columns**

1. The accounts and balances that affect the income statement are transferred from the adjusted trial balance columns to the income statement columns for Sellers Electronix at December 31.
2. All of the amounts in the income statement credit column should be totaled and compared to the total of the amounts in the income statement debit column.

### USING A WORK SHEET

**Balance Sheet Columns**

1. The major difference between the balance sheets of a service company and a merchandising company is inventory.
2. For Sellers Electronix, the ending Merchandise Inventory amount of $40,000 is shown in the balance sheet debit column.
3. The information to prepare the owner’s equity statement is also found in these columns.