COURSE TITLE: FINANCIAL ACCOUNTING

COURSE CODE: ACT 101

COURSE INSTRUCTOR: FAIROSE FARIN

CHAPTER 5: ACCOUNTING FOR MERCHANDISING OPERATIONS

CHAPTER 5 Accounting for Merchandising Operations

ACCOUNTING FOR MERCHANDISING OPERATIONS

Merchandising Operations	Recording Purchases of Merchandise	Recording Sales of Merchandise	Completing the Accounting Cycle	Forms of Financial Statements
• Operating cycles • Flow of costs—perpetual and periodic inventory systems	• Freight costs • Purchase returns and allowances • Purchase discounts • Summary of purchasing transactions	• Sales returns and allowances • Sales discounts	• Adjusting entries • Closing entries • Summary of merchandising entries	• Income statement • Inventory presentation in the classified statement of financial position

✔ The Navigator

ARE MERCHANDISING AND SERVICE COMPANIES SAME ?

MERCHANDISING VS. SERVICE COMPANIES

❑ **Merchandising Companies:**

✓ Buying goods (merchandise) and reselling them for a profit.

✓ The primary source of revenues for merchandising companies is the **sale of merchandise**, often referred to as simply as **sales revenue or sales.**

✓ In Bangladesh, examples of merchandising companies include retailers like **Shwapno, Walmart etc**.

❑ **Service Companies:**

✓ **Providing services** (e.g., consulting, healthcare, transportation, entertainment) ;**make revenue from services rendered**.

✓ Examples of service companies include telecom providers like **Grameenphone** and **Robi Axiata**, financial institutions like **Brac Bank and Islami Bank, and tech companies like BJIT Group.**

MERCHANDISING VS. SERVICE COMPANIES

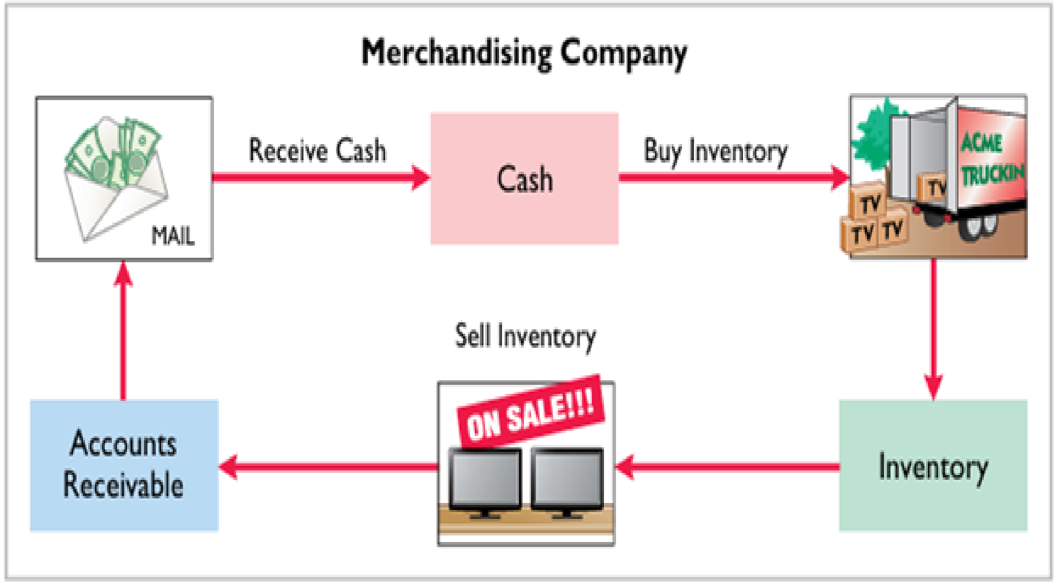
Merchandising Companies	Service Companies
• **Primary Activity:** Buying goods (merchandise) and reselling them for a profit. • **Inventory:** Maintain a stock of goods that they can sell to customers. • **A merchandising company has two categories of expenses :** • **Cost of Goods Sold (COGS):** • **is the total cost of merchandise sold during the period.** This expense is directly related to the revenue recognized from the sale of goods. • **Operating expenses .**	• **Primary Activity:** Providing services (e.g., consulting, healthcare, transportation, entertainment). • **No Inventory:** Does not have inventory of goods to sell. ❑ **A service company has the following expenses :** ❑ **Direct Labor Costs:** The wages and benefits paid to employees who provide the service. • **Direct Operating Costs**: Other expenses directly related to providing the service.

EXAMPLE OF MERCHANDISING OPERATIONS

Imagine a Store That Sells Products (like a clothing store)

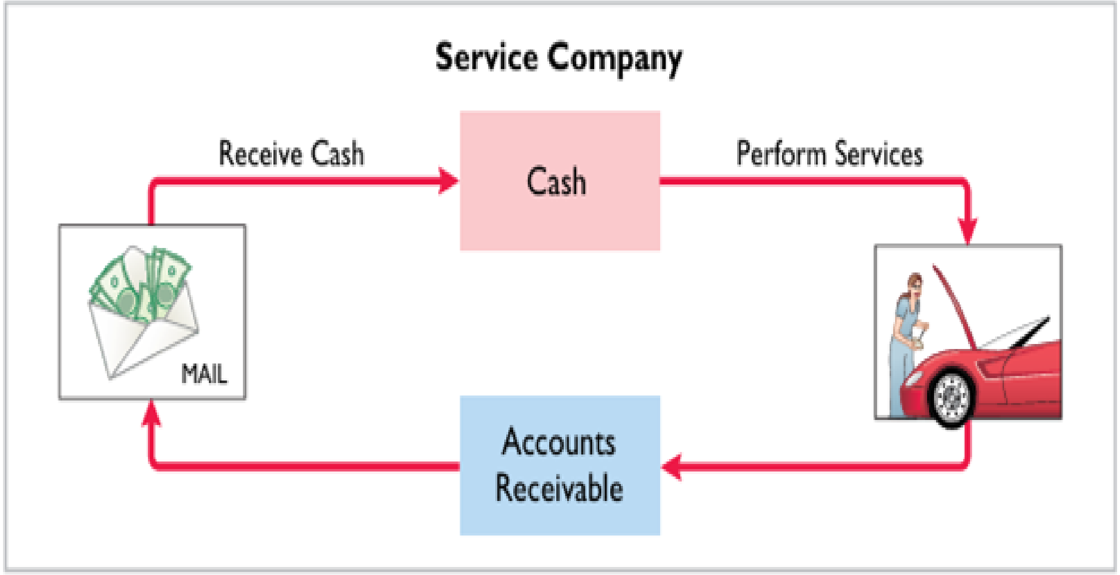
1. **Buying Inventory (Merchandise):**
   The company buys products from suppliers. The money spent here is called **cost of merchandise.**
2. **Storing Inventory:**
   The company keeps these products in stock until customers buy them. This inventory is considered an **asset** on the balance sheet because it holds value.
3. **Selling the Products:**
   When customers buy products, the store earns **sales revenue**.
4. **Cost of Goods Sold (COGS):**
   The cost of the products that were actually sold during the period is called **Cost of Goods Sold (COGS)**. This is the cost of inventory leaving the store

THE OPERATING CYCLE



The operating Cycle of a Merchandising Company.

- ✓ The operating cycle of a merchandising company ordinarily is longer than that of a service company.
- ✓ The purchase of merchandise inventory and its eventual sale lengthen the cycle.



The Operating Cycle of a Service Company

FLOW OF COST

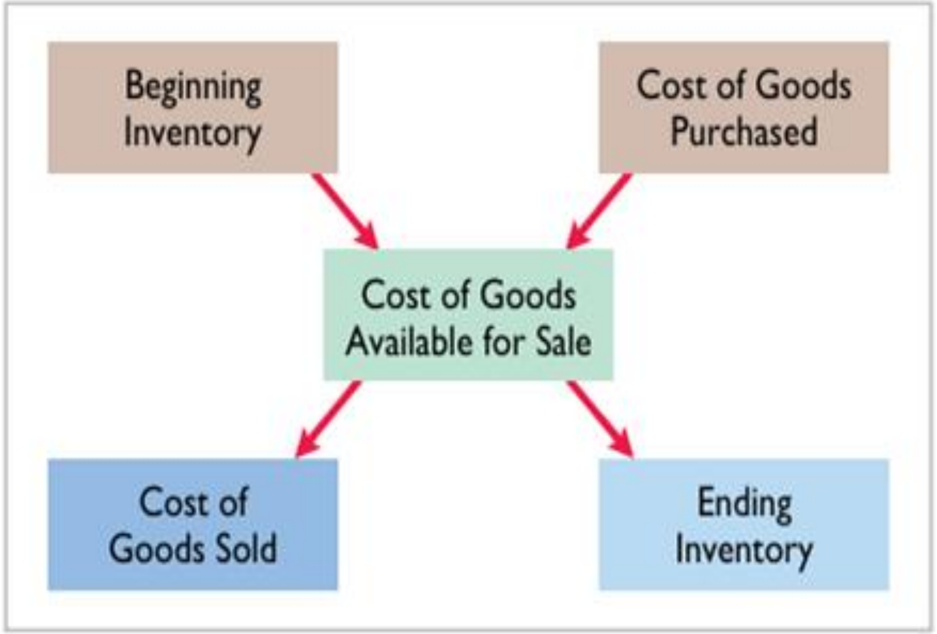
The flow of costs for a **merchandising company** is as follows :

✓ **Starts** with buying merchandise → Costs go into Inventory account (an asset). **Beginning inventory plus the cost of goods purchased is the cost of goods available for sale.**

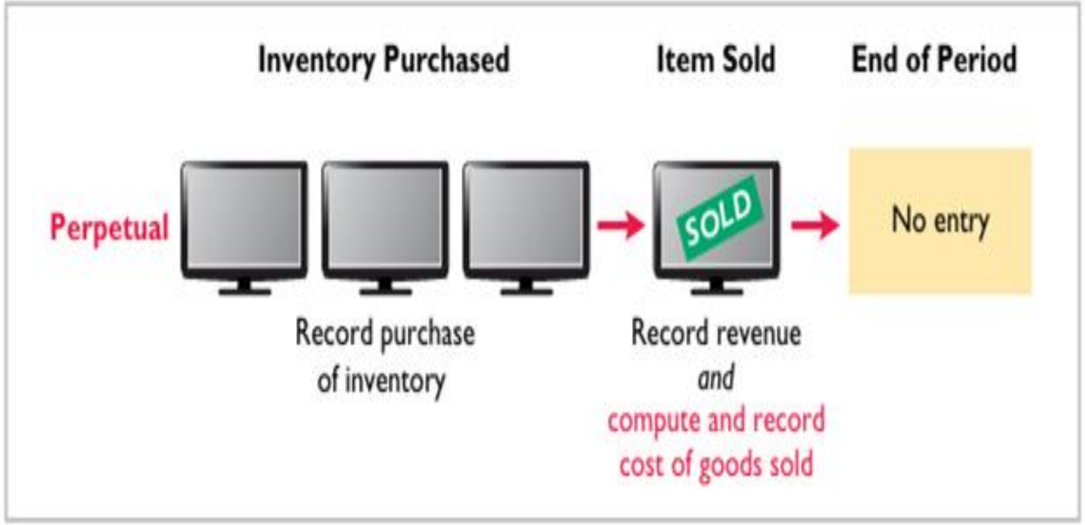
✓ **Then** some merchandise is sold → **Costs move from Inventory to COGS** (an expense on the income statement) .As goods are sold, they are assigned to cost of goods sold.

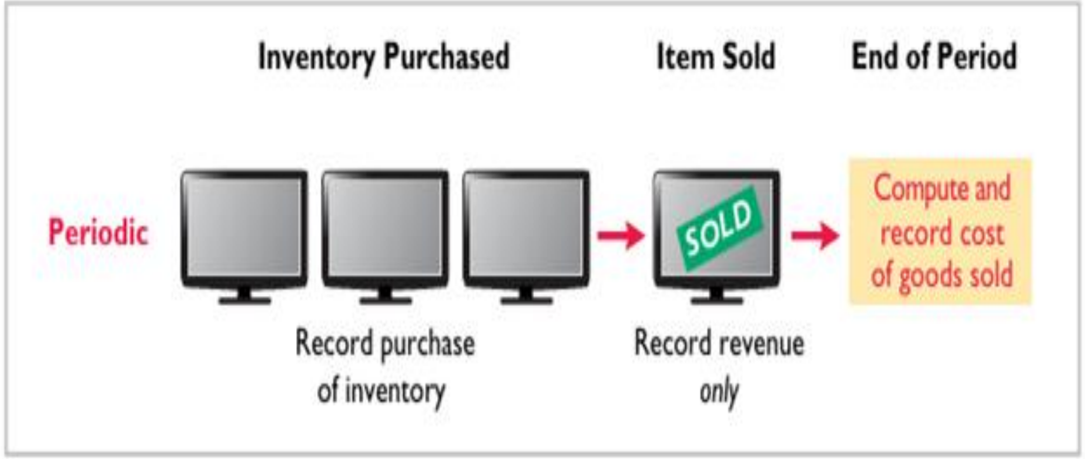
✓ **End** remaining merchandise stays in Inventory (still an asset). Those goods that are not sold by the end of the accounting period represent ending inventory.

This flow helps the company know how much money it spent on products sold versus what is still unsold.



PERPETUAL VS. PERIODIC INVENTORY SYSTEMS





- **In a perpetual inventory system**
- **companies keep detailed records of the cost of each inventory purchase and sale**.
- **Updates inventory levels continuously** as transactions occur- show the inventory that should be on hand for every item.

- **In a periodic inventory system**
- companies **do not keep detailed inventory records of the goods on hand** throughout the period.
- Instead, they **determine the cost of goods sold only at the end of the accounting period.**

PERPETUAL VS. PERIODIC INVENTORY SYSTEMS

Perpetual System	Periodic System
• In a perpetual inventory system, companies keep detailed records of the cost of each inventory purchase and sale. • **Real-time tracking:** Updates inventory levels continuously as transactions occur- show the inventory that should be on hand for every item • **Accuracy:** Provides a more accurate view of inventory levels and cost of goods sold (COGS). • **Benefits:** Reduces errors, improves demand forecasting, and helps minimize stock outs. • **Ideal for: Larger businesses, businesses with high inventory turnover, and businesses requiring real-time inventory data.**	• **Here, companies do not keep detailed inventory records of the goods on hand throughout the period. Instead, they determine the cost of goods sold only at the end of the accounting period.** To determine the cost of goods sold under a periodic inventory system, the following steps are necessary: • **1. Determine the cost of goods on hand at the beginning of the accounting period. 2. Add to it the cost of goods purchased. 3. Subtract the cost of goods on hand at the end of the accounting period** • **Physical counts:** Involves manually counting inventory at set intervals (e.g., monthly, quarterly). • **Ideal for: Smaller businesses with low inventory turnover or businesses where real-time data is not critical.**

Recording Purchases of Merchandise

- Companies purchase inventory using cash or credit (on account). They normally record purchases when they receive the goods from the seller. Every purchase should be supported by business documents that provide written evidence of the transaction.
- **Under the perpetual inventory system, companies record purchases of merchandise for sale in the Inventory account.**

A	=	L	+	E
+3,800				
		+3,800		

Cash Flows
no effect

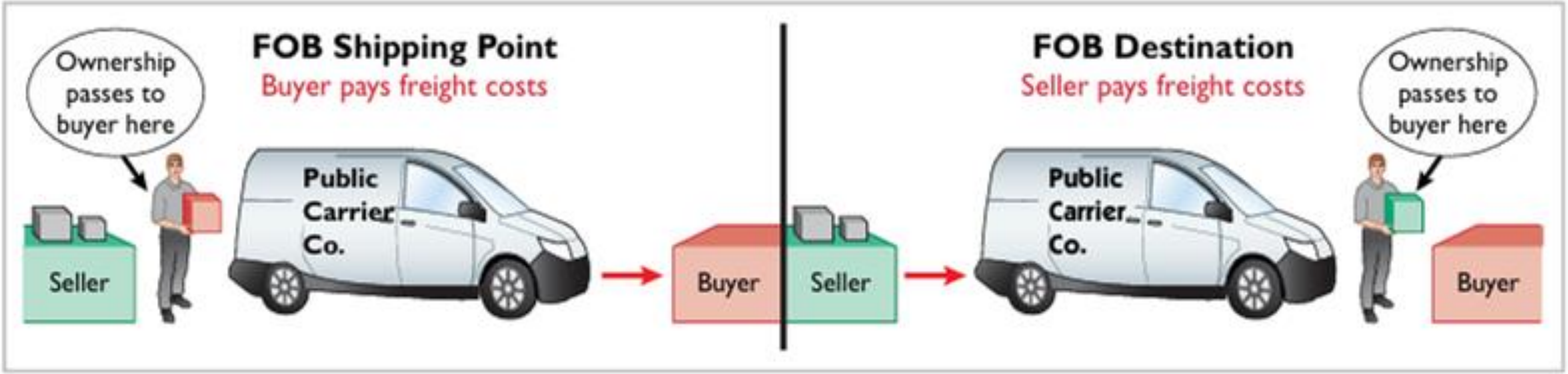
Sauk Stereo makes the following journal entry to record its purchase from PW Audio Supply. The entry increases (debits) Inventory and increases (credits) Accounts Payable.

May 4	Inventory	3,800	
	Accounts Payable		3,800
	(To record goods purchased on account from PW Audio Supply)		

FREIGHT COSTS

The sales agreement should indicate who—the seller or the buyer—is to pay for transporting the goods to the buyer's place of business.

FOB Shipping Point	**FOB Destination**
▪ **FOB shipping point means** that the seller places the goods free on board the carrier, and **the buyer pays the freight costs**.	▪ **FOB destination means** that the seller places the goods free on board to the buyer's place of business, and **the seller pays the freight.**



FREIGHT COSTS INCURRED BY THE BUYER

When the buyer incurs the transportation costs, these costs are considered part of the cost of purchasing inventory. Therefore, the buyer debits (increases) the Inventory account. For example, if Sauk Stereo (the buyer) pays Acme Freight Company €150 for freight charges on May 6, the entry on Sauk Stereo's books is:

May 6	Inventory	150	
	Cash		150
	(To record payment of freight on goods purchased)		

A	=	L	+	E
+150				
−150				

Cash Flows
−150

FREIGHT COSTS INCURRED BY THE SELLER

May 4	Freight-Out (or Delivery Expense)	150	
	Cash		150
	(To record payment of freight on goods sold)		

A	=	L	+	E
				−150 Exp
−150				

Cash Flows
−150

Freight costs incurred by the seller on outgoing merchandise are **an operating expense to the seller.** These costs increase an expense account **titled Freight-Out** (sometimes called **Delivery Expense**). For example, if the freight terms on the invoice had required PW Audio Supply (the seller) to pay the freight charges, the entry by PW Audio Supply would be:

PURCHASE RETURNS AND ALLOWANCES

A purchaser may be dissatisfied with the merchandise received because the goods are damaged or defective, of inferior quality, or do not meet the purchaser's specifications. In such cases, the purchaser may return the goods to the seller for credit if the sale was made on credit, or for a cash refund if the purchase was for cash. This transaction is known as a purchase return.

Sauk Stereo originally **purchased €3,800** worth of inventory for resale. It then **returned €300 of goods**. Assume that Sauk Stereo returned goods costing €300 to PW Audio Supply on May 8. The following entry by Sauk Stereo for the returned merchandise decreases (debits) Accounts Payable and decreases (credits) Inventory.

May 8	Accounts Payable	300	
	Inventory		300
	(To record return of goods purchased from PW Audio Supply)		

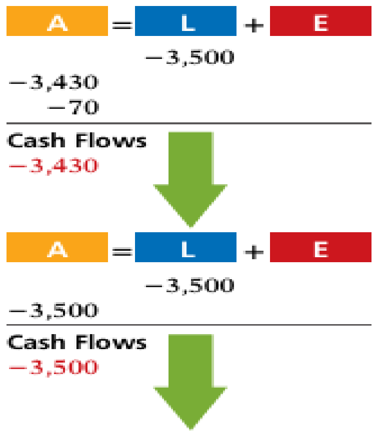
A	=	L	+	E
		−300		
−300				

Cash Flows
no effect

PURCHASE DISCOUNTS

- The **credit terms of a purchase on account** may permit the buyer to claim a cash discount for prompt payment. The buyer calls this cash discount a **purchase discount**.
- Credit terms specify the amount of the cash discount and time period in which it is offered.They also indicate the time period in which the purchaser is expected to pay the full invoice price.
- **This incentive offers advantages to both parties: The purchaser saves money, and the seller is able to shorten the operating cycle by converting the accounts receivable into cash.**
- Assume Sauk Stereo pays the balance due of €3,500 (gross invoice price of €3,800 less purchase returns and allowances of €300) on May 14, the last day of the discount period.

May 14	Accounts Payable	3,500	
	Cash		3,430
	Inventory		70
	(To record payment within discount period)		



PURCHASE TRANSACTIONS

DO IT!

Purchase Transactions

On September 5, Zhū Company buys merchandise on account from Gāo Company. The selling price of the goods is ¥15,000, and the cost to Gāo Company was ¥8,000. On September 8, Zhū returns defective goods with a selling price of ¥2,000. Record the transactions on the books of Zhū Company.

Action Plan

- ✔ Purchaser records goods at cost.
- ✔ When goods are returned, purchaser reduces Inventory.

RECORDING SALES OF MERCHANDISE

To illustrate a credit sales transaction, PW Audio Supply records its May 4 sale of €3,800 to Sauk Stereo (see Illustration 5-6) as follows (**assume the merchandise cost PW Audio Supply €2,400**)

May 4	Accounts Receivable	3,800	
	Sales Revenue		3,800
	(To record credit sale to Sauk Stereo per invoice #731)		
4	Cost of Goods Sold	2,400	
	Inventory		2,400
	(To record cost of merchandise sold on invoice #731 to Sauk Stereo)		

A = L + E
+3,800
+3,800 Rev
Cash Flows
no effect

A = L + E
−2,400 Exp
−2,400
Cash Flows
no effect

Illustration 5-6

SALES RETURNS AND ALLOWANCES

To illustrate a credit sales transaction, PW Audio Supply records its May 4 sale of €3,800 to Sauk Stereo (see Illustration 5-6) as follows (assume the merchandise cost PW Audio Supply €2,400)
If Sauk Stereo returns goods because they are damaged or defective, then PW Audio Supply's entry to Inventory and Cost of Goods Sold should be for the fair value of the returned goods, rather than their cost.

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
	(To record credit granted to Sauk Stereo for returned goods)		
8	Inventory	140	
	Cost of Goods Sold		140
	(To record cost of goods returned)		

A	=	L	+	E
				−300 Rev
−300				

Cash Flows
no effect

A	=	L	+	E
+140				
				+140 Exp

Cash Flows
no effect

SALES DISCOUNTS

As mentioned in our discussion, the seller may offer the customer a cash discount—called by the seller a **sales discount**—for the prompt payment of the balance due. Like a purchase discount, a sales discount is based on the invoice price less returns and allowances, if any. The seller increases (debits) the Sales Discounts account for discounts that are taken. For example, PW Audio Supply makes the following entry to record the cash receipt on May 14 from Sauk Stereo within the discount period.

May 14	Cash	3,430	
	Sales Discounts	70	
	Accounts Receivable		3,500
	(To record collection within 2/10, n/30 discount period from Sauk Stereo)		

A = L + E

+3,430

−70 Rev

−3,500

Cash Flows

+3,430

SALES TRANSACTIONS

> DO IT!

Sales Transactions

On September 5, Zhū Company buys merchandise on account from Gāo Company. The selling price of the goods is ¥15,000, and the cost to Gāo Company was ¥8,000. On September 8, Zhū returns defective goods with a selling price of ¥2,000 and a fair value of ¥300. Record the transactions on the books of Gāo Company.

Action Plan

- ✔ Seller records both the sale and the cost of goods sold at the time of the sale.
- ✔ When goods are returned, the seller records the return in a contra account, Sales Returns and Allowances, and reduces Accounts Receivable.
- ✔ Any goods returned increase Inventory and reduce Cost of Goods Sold. Defective or damaged inventory is recorded at fair value (scrap value).

✔ The Navigator

Summary of Merchandising Entries

	Transactions	Daily Recurring Entries	Dr.	Cr.
Sales Transactions	Selling merchandise to customers.	Cash or Accounts Receivable	XX	
		Sales Revenue		XX
		Cost of Goods Sold	XX	
		Inventory		XX
	Granting sales returns or allowances to customers.	Sales Returns and Allowances	XX	
		Cash or Accounts Receivable		XX
		Inventory	XX	
		Cost of Goods Sold		XX
	Paying freight costs on sales; FOB destination.	Freight-Out	XX	
		Cash		XX
	Receiving payment from customers within discount period	Cash	XX	
		Sales Discounts	XX	
		Accounts Receivable		XX
Purchase Transactions	Purchasing merchandise for resale.	Inventory	XX	
		Cash or Accounts Payable		XX
	Paying freight costs on merchandise purchased; FOB shipping point.	Inventory	XX	
		Cash		XX
	Receiving purchase returns or allowances from suppliers.	Cash or Accounts Payable	XX	
		Inventory		XX
	Paying suppliers within discount period.	Accounts Payable	XX	
		Inventory		XX
		Cash		XX

Events	Adjusting and Closing Entries	Dr.	Cr.
Adjust because book amount is higher than the inventory amount determined to be on hand.	Cost of Goods Sold	XX	
	Inventory		XX
Closing temporary accounts with credit balances.	Sales Revenue	XX	
	Income Summary		XX
Closing temporary accounts with debit balances.	Income Summary	XX	
	Sales Returns and Allowances		XX
	Sales Discounts		XX
	Cost of Goods Sold		XX
	Freight-Out		XX
	Expenses		XX

CLOSING ENTRIES

> DO IT!

Closing Entries

The trial balance of Celine's Sports Wear Shop at December 31 shows Inventory €25,000, Sales Revenue €162,400, Sales Returns and Allowances €4,800, Sales Discounts €3,600, Cost of Goods Sold €110,000, Rent Revenue €6,000, Freight-Out €1,800, Rent Expense €8,800, and Salaries and Wages Expense €22,000. Prepare the closing entries for the above accounts.

Action Plan

- ✔ Close all temporary accounts with credit balances to Income Summary by debiting these accounts.
- ✔ Close all temporary accounts with debit balances, except dividends, to Income Summary by crediting these accounts.

Solution

The two closing entries are:

Dec. 31	Sales Revenue	162,400	
	Rent Revenue	6,000	
	Income Summary		168,400
	(To close accounts with credit balances)		
31	Income Summary	151,000	
	Cost of Goods Sold		110,000
	Sales Returns and Allowances		4,800
	Sales Discounts		3,600
	Freight-Out		1,800
	Rent Expense		8,800
	Salaries and Wages Expense		22,000
	(To close accounts with debit balances)		

Related exercise material: BE5-5, BE5-6, E5-6, E5-7, E5-8, and DO IT! 5-4.

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PRACTICE EXERCISES

1. On June 10, Vareen Company **purchased** £8,000 of merchandise from Harrah Com pany, FOB shipping point, **terms 3/10, n/30**. Vareen pays the **freight costs** of £400 on June 11. **Damaged goods totaling** £300 are **returned** to Harrah for credit on June 12. The **fair value** of these goods in £70. On June 19, Vareen pays Harrah Company in full, less the purchase discount. Both companies use a perpetual inventory system.

Instructions

(a) Prepare separate entries for each transaction on the books of Vareen Company.

(b) Prepare separate entries for each transaction for Harrah Company. The merchandise purchased by Vareen on June 10 had cost Harrah £4,800.

SOLUTION OF PRACTICE EXERCISES

1. (a)

June 10	Inventory	8,000	
	Accounts Payable		8,000
11	Inventory	400	
	Cash		400
12	Accounts Payable	300	
	Inventory		300
19	Accounts Payable (£8,000 – £300)	7,700	
	Inventory		
	(£7,700 × 3%)		231
	Cash (£7,700 – £231)		7,469

(b)

June 10	Accounts Receivable	8,000	
	Sales Revenue		8,000
10	Cost of Goods Sold	4,800	
	Inventory		4,800
12	Sales Returns and Allowances	300	
	Accounts Receivable		300
12	Inventory	70	
	Cost of Goods Sold		70
19	Cash (£7,700 – £231)	7,469	
	Sales Discounts (£7,700 × 3%)	231	
	Accounts Receivable		
	(£8,000 – £300)		7,700

PRACTICE EXERCISES

2. In its income statement for the year ended December 31, 2017, Sun Company Ltd. reported the following condensed data. Interest expense NT$ 70,000 Net sales NT$2,200,000 Operating expenses 725,000 Interest revenue 25,000 Cost of goods sold 1,300,000 Loss on disposal of plant assets 17,000 Instructions Prepare an income statement.

Solution

2.

SUN COMPANY LTD.
Income Statement
For the Year Ended December 31, 2017

Net sales		NT$2,200,000
Cost of goods sold		1,300,000
Gross profit		900,000
Operating expenses		725,000
Income from operations		175,000
Other income and expense		
Interest revenue	NT$25,000	
Loss on disposal of plant assets	(17,000)	8,000
Interest expense		70,000
Net income		NT$ 113,000

The adjusted trial balance columns of Falcetto Company SpA's worksheet for the year ended December 31, 2017, are as follows. (All amounts are in euros.)

	Debit		Credit
Cash	14,500	Accumulated Depreciation— Equipment	18,000
Accounts Receivable	11,100	Notes Payable	25,000
Inventory	29,000	Accounts Payable	10,600
Prepaid Insurance	2,500	Share Capital—Ordinary	50,000
Equipment	95,000	Retained Earnings	31,000
Dividends	12,000	Sales Revenue	536,800
Sales Returns and Allowances	6,700	Interest Revenue	2,500
Sales Discounts	5,000		673,900
Cost of Goods Sold	363,400		
Freight-Out	7,600		
Advertising Expense	12,000		
Salaries and Wages Expense	56,000		
Utilities Expense	18,000		
Rent Expense	24,000		
Depreciation Expense	9,000		
Insurance Expense	4,500		
Interest Expense	3,600		
	673,900		

PRACTICE PROBLEM

Instructions

Prepare an income statement for Falcetto Company SpA.

Solution

FALCETTO COMPANY SpA Income Statement For the Year Ended December 31, 2017		
Sales		
Sales revenue		€536,800
Less: Sales returns and allowances	€ 6,700	
Sales discounts	5,000	11,700
Net sales		525,100
Cost of goods sold		363,400
Gross profit		161,700
Operating expenses		
Salaries and wages expense	56,000	
Rent expense	24,000	
Utilities expense	18,000	
Advertising expense	12,000	
Depreciation expense	9,000	
Freight-out	7,600	
Insurance expense	4,500	
Total operating expenses		131,100
Income from operations		30,600
Other income and expense		
Interest revenue		2,500
Interest expense		3,600
Net income		€ 29,500

SOLUTION OF PRACTICE PROBLEM

E5-2 Information related to Duffy Co., Ltd. is presented below.

1. On April 5, purchased merchandise from Thomas Company, Ltd. for £25,000, terms 2/10, net/30, FOB shipping point.
2. On April 6, paid freight costs of £900 on merchandise purchased from Thomas.
3. On April 7, purchased equipment on account for £26,000.
4. On April 8, returned damaged merchandise to Thomas and was granted a £2,600 credit for returned merchandise.
5. On April 15, paid the amount due to Thomas in full.

Instructions

(a) Prepare the journal entries to record these transactions on the books of Duffy Co., Ltd. under a perpetual inventory system.

(b) Assume that Duffy Co., Ltd. paid the balance due to Thomas Company, Ltd. on May 4 instead of April 15. Prepare the journal entry to record this payment.

E5-3 On September 1, Moreau Office Supply SA had an inventory of 30 calculators at a cost of €22 each. The company uses a perpetual inventory system. During September, the following transactions occurred.

Sept.	6	Purchased with cash 90 calculators at €20 each from Roux Co. SA, terms 2/10, n/30.
	9	Paid freight of €180 on calculators purchased from Roux Co.
	10	Returned 3 calculators to Roux Co. for €66 credit (including freight) because they did not meet specifications.
	12	Sold 28 calculators costing €22 (including freight) for €33 each to Village Book Store, terms n/30.
	14	Granted credit of €33 to Village Book Store for the return of one calculator that was not ordered.
	20	Sold 40 calculators costing €22 for €35 each to Holiday Card Shop, terms n/30.

Instructions

Journalize the September transactions.

ASSIGNMENT

E5-4 On June 10, York Company Ltd. purchased £7,600 of merchandise from Bianchi Company, FOB shipping point, terms 2/10, n/30. York pays the freight costs of £400 on June 11. Damaged goods totaling £300 are returned to Bianchi for credit on June 12. The fair value of these goods is £70. On June 19, York pays Bianchi Company in full, less the purchase discount. Both companies use a perpetual inventory system.

Instructions

(a) Prepare separate entries for each transaction on the books of York Company, Ltd.

(b) Prepare separate entries for each transaction for Bianchi Company. The merchandise purchased by York on June 10 had cost Bianchi £4,300.

E5-5 Presented below are transactions related to Li Company, Ltd.

1. On December 3, Li sold HK$580,000 of merchandise to South China Co., Ltd. terms 1/10, n/30, FOB shipping point. The cost of the merchandise sold was HK$364,800.
2. On December 8, South China was granted an allowance of HK$28,000 for merchandise purchased on December 3.
3. On December 13, Li received the balance due from South China.

Instructions

(a) Prepare the journal entries to record these transactions on the books of Li Company, Ltd. using a perpetual inventory system.

(b) Assume that Li Company, Ltd. received the balance due from South China Co., Ltd. on January 2 of the following year instead of December 13. Prepare the journal entry to record the receipt of payment on January 2.

ASSIGNMENT