CHAPTER 5_ACCOUNTING FOR MERCHANDSING OPERATIONS

Chapter Outline | **Notes**

I. Merchandising Activities

A. Merchandise consists of products, also called goods, that a company acquires to resell to customers. Merchandisers can be either wholesalers (those that buy from manufacturers or other wholesalers and sell to retailers or other wholesalers) or retailers (those that buy from wholesalers or manufacturers and sell to consumers).

B. Reporting Income for a Merchandiser
Revenue from selling merchandise (*net sales*) minus the cost of goods (merchandise) sold to customers is called *gross profit*. Gross profit minus expenses (generally called *operating expenses*) determines the net income or loss for the period.

C. Reporting Inventory for a Merchandiser
A merchandiser's balance sheet is the same as service businesses with the exception of one additional *current* asset called:

1. *Merchandise Inventory,* or *Inventory*, refers to products 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 Merchandiser
Begins by purchasing merchandise and ends by collecting cash from selling the merchandise.

E. Inventory Systems
Two alternative inventory systems that can be used to collect information about the cost of goods sold and the inventory (cost of goods available) are:

II. Accounting for Merchandise Purchases
The *invoice* serves as a *source document* for this event.

A. Trade Discounts
Deductions from list price (catalog price) to arrive at invoice price (actual selling price). Trade discounts are not entered into accounts.

1. Transactions are recorded using invoice price.
2. Entry to record purchase: debit Inventory, credit Cash or Accounts Payable.

B. Purchase Discounts
Credit terms describe cash discounts offered to purchasers by seller for payment within a specified period of time called the *discount period.* Buyers view cash discounts as purchase discounts and sellers view them as sales discounts.

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. Entry (for buyer) for payment within discount period: debit

Accounts Payable (full invoice amount), credit Cash (amount paid = invoice – discount), credit Inventory (amount of discount).

C. 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.

D. Purchase Returns and Allowances
1. *Purchase returns* refers to merchandise a buyer acquires but then returns to the seller.
2. A *purchase allowance* is a reduction in the cost of defective merchandise that a buyer acquires.
3. A *debit memorandum* is a document that a buyer issues to inform the seller of a debit made to the seller's account in the buyers records.
4. Entry on buyer's books: debit Accounts Payable or Cash (if refund given) and credit Inventory.

E. Discounts and Returns
Discounts can only be taken on the remaining balance on the invoice after the return.

F. Transportation Costs and Ownership Transfer
The point at which ownership is transferred (called FOB or *free on board*) determines who is responsible for paying any freight costs and/or bearing any loss. Two alternative points of title transfer are:
1. FOB shipping point—title transfers at shipping point and buyer bears any loss and 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 bears any loss and pays shipping costs.
    a. Operating expense for seller
    b. Debit Delivery Expense (or Transportation-Out or Freight-Out), credit Cash.

G. Recording Purchases Information
The net cost of purchased merchandise according to the *cost principle* is recorded in the inventory account. (Inventory is debited, or increased, for invoice and transportation costs, and credited, or reduced, for returns, allowances, and discounts. *Supplemental records* are often used to collect information about each of the cost elements for management to evaluate and control.

III. Accounting for Merchandise Sales—involves sales, sales discount, sales returns and allowances and cost of goods sold

A. Each sale of merchandise transaction involves two parts; the revenue and the cost.

1. **Recognize revenue—debit Accounts Receivable (or cash), credit Sales (both for the invoice amount).**
2. **Recognize cost—debit Cost of Goods Sold, credit Inventory (both for the cost of the inventory sold).**

B. Sales Discounts
Cash discounts awarded to customers for payment within the discount period. Recorded upon collection for sale.

1. Collection after discount period—Debit Cash, Credit Accounts Receivable (full invoice amount).
2. Collection within discount period—debit Cash (invoice amount less discount), debit Sales Discount (discount amount), credit Accounts Receivable (invoice amount).
3. Sales Discounts is a contra-revenue account—subtraction from Sales.

C. Sales Returns and Allowances

1. *Sales returns*—merchandise that a customer returned to the seller after a sale.
2. *Sales allowances*—reductions in the selling price of merchandise sold to customers (usually for damaged merchandise that a customer is willing to keep at a reduced price).

IV. Completing the Accounting Cycle

A. Adjusting Entries for Merchandisers
Generally same as discussed in chapter 4 for a service business with an additional adjustment needed to update inventory to reflect any loss referred to as *shrinkage*.

1. Shrinkage is determined by comparing a physical count of the inventory with recorded quantities.
2. Adjusting entry: debit Cost of Goods Sold, credit Inventory.

B. Preparing Financial Statements

Statements similar to service business with the following differences:

1. Income Statement includes the *cost of goods sold* and *gross profit*. Also, net sales is affected by discounts, returns, and allowances and delivery expense as an additional possible expense.
2. Balance Sheet includes *merchandise inventory* as part of current assets.

C. Closing Entries
Similar to a service business except there are additional temporary accounts to close (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. Financial Statement Formats—GAAP does not require any specific format. Common formats:

A. Multiple-Step Income Statement—shows details of net sales and other costs and expenses. Has three main parts:

1. *Gross profit*—net sales less cost of goods sold.
2. *Income from operations*—gross profit less operating expenses (classified into selling and general & administrative).
3. *Net income*—Income from operations adjusted for nonoperating items.

B. Single-Step Income Statement
Lists cost of goods sold as another expense and shows only one subtotal for total expenses, one subtraction to arrive at net income.

C. Classified Balance Sheet—reports merchandise inventory as a current asset, usually after accounts receivable (use liquidity order).