

CHAPTER

5

Accounting for Merchandising Operations

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Identify the differences between service and merchandising companies.
2. Explain the recording of purchases under a perpetual inventory system.
3. Explain the recording of expenses at merchandising companies.
4. Explain the recording of sales revenues under a perpetual inventory system.
5. Prepare an income statement for a merchandiser.

5-2

Merchandising Operations

Merchandising Companies

Buy and Sell Goods

Retailer



Learning Objective 1
Identify the differences between service and merchandising companies.

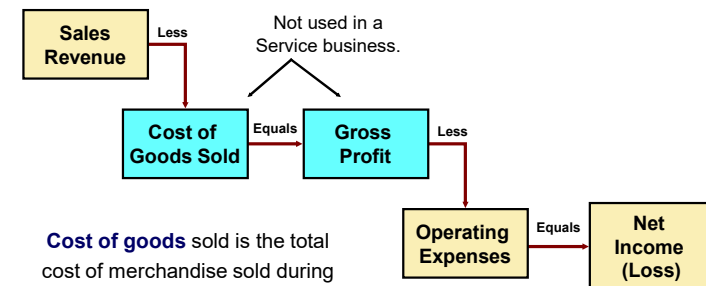


The primary source of revenues is referred to as **sales revenue** or **sales**.

5-3

Merchandising Operations

Income Measurement

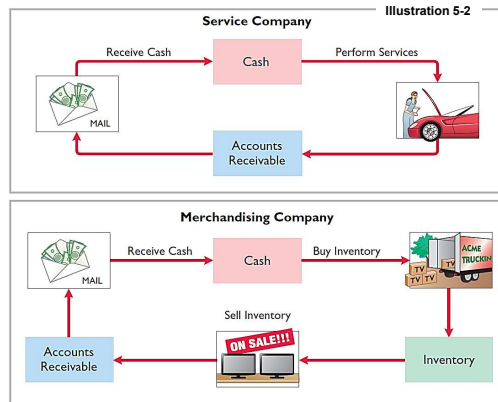


Cost of goods sold is the total cost of merchandise sold during the period.

5-4

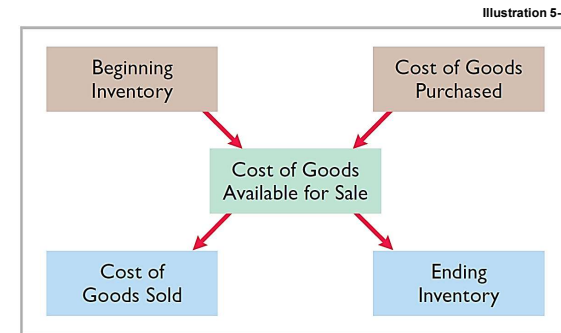
Operating Cycles

The operating cycle of a **merchandising company** ordinarily is longer than that of a **service company**.



5-5

Flow of Costs



Companies use either a **perpetual inventory system** or a **periodic inventory system** to account for inventory.

5-6

Flow of Costs

PERPETUAL SYSTEM

- ◆ Maintain detailed records of the cost of each inventory purchase and sale.
- ◆ Records continuously show inventory that should be on hand for every item.
- ◆ Company determines cost of goods sold each time a sale occurs.

5-7

Flow of Costs

PERIODIC SYSTEM

- ◆ Do not keep detailed records of the goods on hand.
- ◆ Cost of goods sold determined by count at the end of the accounting period.
- ◆ Calculation of Cost of Goods Sold:

Beginning inventory	€ 100,000
Add: Purchases, net	800,000
Goods available for sale	<u>900,000</u>
Less: Ending inventory	125,000
Cost of goods sold	<u><u>€ 775,000</u></u>

5-8

Flow of Costs

ADVANTAGES OF THE PERPETUAL SYSTEM

- ◆ Traditionally used for merchandise with high unit values.
- ◆ Shows the quantity and cost of the inventory that should be on hand at any time.
- ◆ Provides better control over inventories than a periodic system.

5-9

INVESTOR INSIGHT

Snowboard Company Improves Its Share Appeal

Investors are often eager to invest in a company that has a hot new product. However, when a fast-growing snowboard-maker issued ordinary shares to the public for the first time, some investors expressed reluctance to invest in it because of a number of accounting control problems. To reduce investor concerns, the company implemented a perpetual inventory system to improve its control over inventory. In addition, the company stated that it would perform a physical inventory count every quarter until it felt that its perpetual inventory system was reliable.

5-10

> DO IT!

Indicate whether the following statements are **true** or **false**.

1. The primary source of revenue for a merchandising company results from performing services for customers.
2. The operating cycle of a service company is usually shorter than that of a merchandising company.
3. Sales revenue less cost of goods sold equals gross profit.
4. Ending inventory plus the cost of goods purchased equals cost of goods available for sale.

5-11

Recording Purchases of Merchandise

- ◆ Made using **cash or credit** (on account).
- ◆ Normally **record when** goods are received from the seller.
- ◆ **Purchase invoice** should support each credit purchase.

Learning Objective 2
Explain the recording of purchases under a perpetual inventory system.

PW AUDIO SUPPLY, SE 27 CIRCLE DRIVE AMSTERDAM, THE NETHERLANDS 1081				
INVOICE NO. 711				
Firm Name: <u>Stack Phones</u>				
Attention of: <u>Janine Hoovers, Purchasing Agent</u>				
Address: <u>125 Main Street</u>				
City: <u>Birmingham</u> State: <u>285</u>				
Date: 5/4/17	Salesperson: Malone	Terms: 2/10, n/30	FOB Shipping Point	
Casting No.	Description	Quantity	Price	Amount
3372Y9820	Printed Circuit Board-prototype	1	2,300	2,300
A8547245	Production Model Circuit	5	300	1,500
TOTAL				3,800
IMPORTANT: ALL RETURNING MUST BE MADE WITHIN 10 DAYS				

5-12

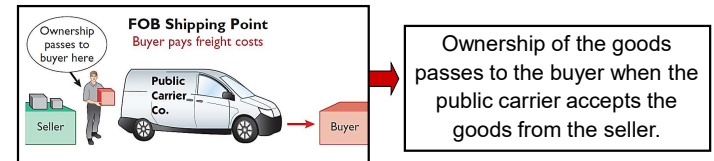
Recording Purchases of Merchandise

Illustration: Sauk Stereo (**the buyer**) uses as a purchase invoice the sales invoice prepared by PW Audio Supply, Inc. (**the seller**). **Prepare the journal entry** for Sauk Stereo for the invoice from PW Audio Supply.

PW AUDIO SUPPLY, SE 27 CIRCLE DRIVE AMSTERDAM, THE NETHERLANDS 1081					
INVOICE NO. 121					
S	Firm Name Sauk Stereo				
O	Attention of Jansen Brouwer, Purchasing Agent				
D	Address 140 Main Street				
T	City Bunnik				
O	Date 8/8				
Date	5/4/17	Salperson	Melissa	Series	2/10, 5/10
Catalog No.	Description	Quantity	Price	Amount	
23787Y880	Printed Circuit Board prototype	1	8,300	€8,300	
A2847240	Production Model Circuit	5	300	1,500	
TOTAL					€9,800

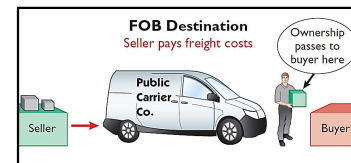
5-13

Freight Costs



Ownership of the goods passes to the buyer when the public carrier accepts the goods from the seller.

Freight costs incurred by the buyer are an **add-in asset value**.



Ownership of the goods remains with the seller until the goods reach the buyer.

Freight costs incurred by the seller are a **selling expense**.

5-14

Freight Costs

Illustration: Assume upon delivery of the goods on May 6, **Sauk Stereo (the buyer)** pays Public Freight Company €150 for **freight charges**, the entry on Sauk Stereo's books is:

Assume the freight terms on the invoice in Illustration 5-6 had required **PW Audio Supply (the seller)** to pay the **freight charges**, the entry by PW Audio Supply would have been:

5-15

Purchase Returns and Allowances

Purchaser may be dissatisfied because goods are damaged or defective, of inferior quality, or do not meet specifications.

Purchase Return

Return goods for credit if the sale was made on credit, or for a cash refund if the purchase was for cash.

Purchase Allowance

May choose to keep the merchandise if the seller will grant a reduction from the purchase price.

5-16

Purchase Returns and Allowances

Illustration: Assume Sauk Stereo returned goods costing €300 to PW Audio Supply on May 8.

5-17

Purchase Returns and Allowances

Question

In a perpetual inventory system, a return of defective merchandise by a purchaser is recorded by crediting:

- a. Purchases
- b. Purchase Returns
- c. Purchase Allowance
- d. Inventory

5-18

Purchase Discounts

Credit terms may permit buyer to claim a cash discount for large amount purchasing.

Advantages:

- ♦ Purchaser saves money.
- ♦ Seller shortens the operating cycle by converting the accounts receivable into cash earlier.

5-19

Purchase Discounts

Illustration: 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 seller offer €70 discount for large purchasing. Prepare the journal entry Sauk Stereo makes on May 14 to record the payment.

5-20

Summary of Purchasing Transactions

Inventory	
Debit	Credit
Balance	

5-21

> DO IT!

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

5-22

Recording Expenses

Learning Objective 3
Explain the recording of expenses at merchandising companies.

Major Expenses at merchandising companies:

- ◆ Cost of Goods Sold
- ◆ Tools and supplies consuming
- ◆ Services consuming
- ◆ Depreciation of fixed assets
- ◆ Wage and Wage-relate

5-23

Recording tools and supplies consuming

- ◆ If costs of tools and supplies relate to an accounting period, they shall be wholly recorded to operating expenses as follows:

Expenses	XXX
Tools and supplies	XXX

5-24

Recording tools and supplies consuming

- ◆ If costs of tools and supplies relate to more than one accounting period, they shall be gradually recorded to operating expenses:

- When dispatching tools and supplies:

Prepaid expenses	XXX	
Tools and supplies		XXX

- When distributing to costs of operation for every accounting period:

Expenses	XXX	
Prepaid expenses		XXX

5-25

Recording Services consuming

- ◆ Expenses of telephone, electricity and water outsourced (for an accounting period), record:

Expense	XXX	
Cash or Account payables		XXX

- ◆ If services relate to more than one accounting period, they shall be gradually recorded to operating expenses:

Prepaid expenses	XXX	
Cash or Account payables		XXX

Expenses	XXX	
Prepaid expenses		XXX

5-26

Recording Depreciation of fixed assets

- ◆ Periodically, when calculating, deducting and recording fixed assets to operating costs:

Expenses	XXX	
Depreciation of fixed assets		XXX

5-27

Recording Wage Expense

- ◆ When determining salaries payable to staff and other employees as prescribed:

Expenses	XXX	
Payables to employees		XXX

- ◆ When paying salaries to staff and other employees:

Payables to employees	XXX	
Cash		XXX

5-28

Recording Wage-relate Expense

	Total	Firms'	Employee s'	Account code
Trade union fee	2%	2%	0%	3382
Social insurance	25%	17%	8%	3383
Health insurance	4,5%	3%	1,5%	3384
Unemployment insurance	1%	0%	1%	3386

- ◆ When appreciating social insurance, health insurance, unemployment insurance, or trade union fees


Expenses	XXX
Other payable	XXX

5-29

Recording Sales of Merchandise

- ◆ Made using **cash or credit** (on account).
- ◆ Sales revenue, like service revenue, is recorded when the performance obligation is satisfied.
- ◆ Performance obligation is satisfied when the goods are transferred from the seller to the buyer.
- ◆ Sales invoice should support each credit sale.

INVOICE NO. 731


PW AUDIO SUPPLY, SE
27 CIRCLE DRIVE
AMSTERDAM, THE NETHERLANDS 1081

S Firm Name Bank Boreo

O Attention of JAMES HOOVER, Purchasing Agent

D Address 129 Main Street

T City Murphy State MS.

Date 8/4/74	Shipperson	Machine	Terms 2/10, n/30	FOB Shipping Point	Quantity	Price	Amount
X57829680		Printed Circuits Board prototype			1	2,300	€2,300
A0497245		Production Model Circuitrite			5	300	1,500
IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 60 DAYS							TOTAL €3,800

5-30

Major Sale transactions



5-31

Recording Direct Sale

Journal Entries to Record a Sale

#1	Cash or Accounts Receivable	XXX	} Selling Price
	Sales Revenue	XXX	
#2	Cost of Goods Sold	XXX	} Cost
	Merchandise Goods	XXX	

5-32

Recording Direct Sale

Illustration: PW Audio Supply records the sale of €3,800 on May 4 to Sauk Stereo on account (Illustration 5-6) as follows (assume the merchandise cost PW Audio Supply €2,400).

5-33

Recording Sale via Agents

#1 Merchandise transferred to Agents			
Goods on consignment	XXX		} Cost
Merchandise Goods		XXX	
#2 Goods on consignment sold			
Cash or Accounts Receivable	XXX		} Selling Price
Sales Revenue		XXX	
Cost of Goods Sold	XXX		} Cost
Goods on consignment		XXX	

5-34

Recording Sale via Agents

Illustration: PW Audio Supply records the merchandise transferring of €1,200 on May 8 to Thanos (an agent). On May 15, Thanos confirm that all merchandise was sold for €1,900

5-35

ANATOMY OF A FRAUD

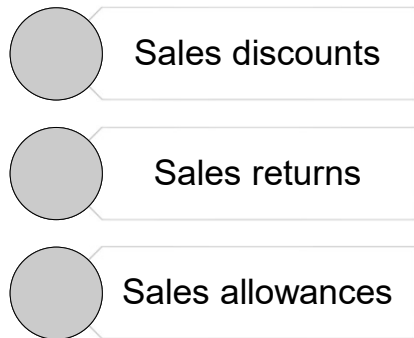
Holly Harmon was a cashier at a national superstore for only a short while when she began stealing merchandise using three methods. Under the first method, her husband or friends took UPC labels from cheaper items and put them on more expensive items. Holly then scanned the goods at the register. Using the second method, Holly scanned an item at the register but then voided the sale and left the merchandise in the shopping cart. A third approach was to put goods into large plastic containers. She scanned the plastic containers but not the goods within them. One day, Holly did not call in sick or show up for work. In such instances, the company reviews past surveillance tapes to look for suspicious activity by employees. This enabled the store to observe the thefts and to identify the participants.

Total take: \$12,000

The Missing Controls

5-36

Recording Sales Deductions



5-37

Sales Discount

- ♦ Offered to customers to **promote large amount purchasing**.
- ♦ **Contra-revenue account** (debit) to Sales Revenue.

Sales Revenue	Sales Returns and Allowances	Sales Discounts
3,800	300	70
<div>↓ ↓ ↓</div> Net Sales €3,430		

5-38

Sales Discount

Illustration: 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, PW Audio offers €70 discount for large purchasing. Prepare the journal entry PW Audio Supply makes to record the receipt on May 14.

5-39

Sales Returns and Allowances

- ♦ **“Flip side”** of purchase returns and allowances.
- ♦ **Contra-revenue account** to Sales Revenue (debit).
- ♦ **Sales not reduced** (debited) because:
 - ▶ Would obscure importance of sales returns and allowances as a percentage of sales.
 - ▶ Could distort comparisons.

5-40

Sales Returns

Illustration: Prepare the entry PW Audio Supply would make to record the credit for returned goods that had a €300 selling price (assume a €140 cost).

5-41

Sales Allowances

Illustration: Prepare the entry PW Audio Supply would make to record the allowance of €200 to compensate for a group of under quality merchandises sold.

5-42

Sales Returns and Allowances

Question

The cost of goods sold is determined and recorded each time a sale occurs in:

- a. periodic inventory system only.
- b. a perpetual inventory system only.
- c. both a periodic and perpetual inventory system.
- d. neither a periodic nor perpetual inventory system.

5-43

ACCOUNTING ACROSS THE ORGANIZATION

Merchandiser's Accounting Causes Alarm

Accounting for merchandising transactions is not always as easy as it might first appear. Recently, **Tesco** (GBR) announced that it had overstated profits by £263 million over a three-year period. The error related to how Tesco accounted for amounts received from suppliers for promotional activities of those companies' products. When a retailer runs advertisements promoting a particular product, the producer of that product shares part of the advertising cost. Typically, the producer pays the merchandiser its share of the advertising cost as much as a year before the advertisement is run. The questions become, how should these amounts be reported by the merchandiser at the time it receives the funds, and when should these amounts affect income? The scandal surrounding this accounting treatment was serious enough that it caused the company's chairman to resign, and an outside auditing firm was brought in to investigate. One analyst commented that "we can never recall a period so damaging to the reputation of the company."

Source: Jenny Anderson, "Tesco Chairman to Step Down as Overstatement of Profit Grows," *The New York Times Online* (October 23, 2014).

5-44

Principles of Accounting

> DO IT!

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

5-45

> DO IT!

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

5-46

Closing Entries

Dec. 31	Sales Revenue	480,000	
	Income Summary		480,000
	(To close income statement accounts with credit balances)		
31	Income Summary	450,000	
	Cost of Goods Sold		316,000
	Salaries and Wages Expense		64,000
	Utilities Expense		17,000
	Advertising Expense		16,000
	Sales Returns and Allowances		12,000
	Sales Discounts		8,000
	Depreciation Expense		8,000
	Freight-Out		7,000
	Insurance Expense		2,000
	(To close income statement accounts with debit balances)		

5-47

Closing Entries

Dec. 31	Income Summary	30,000	
	Retained Earnings		30,000
	(To close net income to retained earnings)		
31	Retained Earnings	15,000	
	Dividends		15,000
	(To close dividends to retained earnings)		

5-48

> DO IT!

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.

5-49

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.

5-50

Forms of Financial Statements

Income Statement

- ◆ Primary source of information for evaluating a company's performance.
- ◆ Format is designed to differentiate between the various sources of income and expense.

Learning Objective 5
Prepare an income statement for a merchandiser.

5-51

Income Statement

The income statement is a primary source of information for evaluating a company's performance.

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
Sales revenue		€480,000
Less: Sales returns and allowances	€12,000	
Sales discounts	8,000	20,000
Net sales		460,000
Cost of goods sold		316,000
Gross profit		144,000
Operating expenses		
Salaries and wages expense	64,000	
Utilities expense	17,000	
Advertising expense	16,000	
Depreciation expense	8,000	
Freight-out	7,000	
Insurance expense	2,000	
Total operating expenses		114,000
Income from operations		30,000
Other income and expense		
Interest revenue	3,000	
Gain on sale of equipment	600	
Casualty loss from vandalism	(200)	3,400
Interest expense		1,800
Net income		€ 31,600

5-52

Income Statement

Key Items:

- ◆ Net sales

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Freight-out	7,000		
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Total operating expenses		114,000	
Income from operations			30,000
Other income and expense			
Interest revenue	3,000		
Gain on sale of equipment	600		
Casualty loss from vandalism	(200)	3,400	
Interest expense		1,800	
Net income			€ 31,600

5-53

Income Statement

Key Items:

- ◆ Net sales
- ◆ Gross profit

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5-54

Income Statement

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Gross profit			144,000
Operating expenses			
Salaries and wages expense	64,000		

Gross Profit	÷	Net Sales	=	Gross Profit Rate
€144,000	÷	€460,000	=	31.3%

Illustration 5-11
Gross profit rate formula and computation

Total operating expenses	114,000	
Income from operations		30,000
Other income and expense		
Interest revenue	3,000	
Gain on sale of equipment	600	
Casualty loss from vandalism	(200)	3,400
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Income Statement

Key Items:

- ◆ Net sales
- ◆ Gross profit
- ◆ Operating expenses

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Income Statement

Key Items:

- ◆ Net sales
- ◆ Gross profit
- ◆ Operating expenses
- ◆ Other income and expense

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Net income			€ 31,600

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Income Statement

Key Items:

- ◆ Net sales
- ◆ Gross profit
- ◆ Operating expenses
- ◆ Other income and expense

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017			
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Operating expenses			
Salaries and wages expense	64,000		
Utilities expense	17,000		
Advertising expense	16,000		
Depreciation expense	8,000		
Other Income			
Interest revenue from notes receivable and marketable securities.			
Dividend revenue from investments in ordinary shares.			
Rent revenue from subleasing a portion of the store.			
Gain from the sale of property, plant, and equipment.			
Other Expenses			
Casualty losses from causes such as vandalism and accidents.			
Loss from the sale or abandonment of property, plant, and equipment.			
Loss from strikes by employees and suppliers.			

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Income Statement

Key Items:

- ◆ Net sales
- ◆ Gross profit
- ◆ Operating expenses
- ◆ Other income and expense
- ◆ Interest expense

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017			
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Interest revenue	3,000		
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Interest expense		1,800	
Net income			€ 31,600

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Income Statement

Key Items:

- ◆ Net sales
- ◆ Gross profit
- ◆ Operating expenses
- ◆ Other income and expense
- ◆ Interest expense
- ◆ Net income

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017			
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Income from operations			30,000
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Casualty loss from vandalism	(200)	3,400	
Interest expense		1,800	
Net income			€ 31,600

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Income Statement

1	Sales	
2	Revenue deductions	
3	Net sales	(3)=(1)-(2)
4	Costs of goods sold	
5	Gross profit	(5)=(3)-(4)
6	Selling expenses	
7	General administration expenses	
8	Operating profit	(8)=(5)-(6)-(7)

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Income Statement

Question

The income statement for a merchandiser shows each of the following features **except**:

- a. gross profit.
- b. cost of goods sold.
- c. a sales section.
- d. investing activities section.

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