Chapter 4 – Merchandising Operations
MGMT 1A

A. Merchandising Activities *- A "merchandiser"? Earns income from buying and selling merchandise or goods. Like Target, Nordstrom.*

1. Merchandise – products or goods that a Company buys to resell to customers *Targets merchandise = Clothes, groceries, cleaning products, books, medicine.*

2. Revenues from selling merchandise = Sales *(A service provider has "Revenue"; A merchandiser has "Sales" because they sell products)*

   a. Expense of buying and preparing merchandise = Cost of Goods Sold (COGS)

3. Merchandise Inventory = B*alance*___ S*heet*___ account

Inventory

Beginning Inventory *+ Net Purchases*	
Merchandise Available for Sale	 *COGS*
Ending Inventory	

B. Accounting for Purchases of Merchandise Inventory *(Two methods)*

1. P*erpetual*_______ – Update the accounting records for each purchase and sale of inventory

   a. Class Example: On _*4/1*__ Target purchases _*1,000*__ units of LOL Surprise on credit from Jakks Pacific (manufacturer) for _*$1,500*_. Full payment is due in 30 days (_*n30*__).

   Target gets the inventory on 4/1, but they don't have to pay (cash) for it until 4/30. What will Target do with the products during those 30 days? Sell them and collect cash from their customers. Then Target uses that cash to pay the bill.

4/1:	*DR: Inventory*	*$1,500*	
	CR: Accounts Payable		*$1,500*
	(To record purchase of goods on account)		
4/30:	*DR: Accounts Payable*	*$1,500*	
	CR: Cash		*$1,500*
	(To record payment of invoice)		

2. P*eriodic*___ – Update the accounting records for purchase and sales of inventory only at the end of a period *(We cover this in Ch. 5)*

3. Discounts

   a. T*rade*_ discounts = incentive for purchaser to buy more goods; they _*ARE NOT*_ journalized.

   b. C*ash*____ discounts = incentive for purchaser to pay sooner; they _*ARE*_ journalized.

   c. Class Example continued: On __*4/1*__ Target purchases _*1,000*_ units of LOL Surprise on credit from Jakks Pacific (manufacturer) for $_*1,500*_. Full payment is due in 30 days, but a _*2%*_ discount is available if paid within _*30*_days. (_*2/10*_, _*n30*_).
   (We say, "Two in Ten, Net 30" – it means, a 2% discount if you pay in 10 days, otherwise the whole balance is due in 30 days)

   Assume Target pays the invoice on _*4/11*__: *← This would be the 10th day (we don't count 4/1. That is Day Zero)*

4/1: DR: Inventory $1,500
CR: Accounts Payable $1,500
(To record purchase of goods on account)
4/11: DR: Accounts Payable $1,500
*CR: Merchandise Inventory $30 ← $1,500 * 2% discount*
*CR: Cash $1,470 ← $1,500 * 98% discount*
(Record payment of invoice within the discount period)

   Assume Target did not pay the invoice until ___*4/12*___:

4/11: DR: Accounts Payable $1,500
CR: Cash $1,500

   Good cash management means not paying the invoice until the LAST day of the discount period. The Company could invest it elsewhere and earn income while waiting to pay

   d. G*ross*_ method – initially record the invoice at the g*ross*_ amount *– what we just did*

   e. N*et*__ method – initially record the invoice n*et*_ of any cash discount *– reduce the A/P*

f. Class Example continued: Record the above sale of merchandise to Target on _*4/1*__ using the net method:

4/1: DR: Inventory $1,470
*CR: Accounts Payable $1,470 ← $1,500 * (1-2%)*
(To record purchase of goods on account, net of 2% discount)

Assume that Target pays the invoice on _*4/11*__. Record the payment:

4/11: DR: Accounts Payable $1,470
CR: Cash $1,470
(Record payment of invoice within the discount period)

Assume instead Target did not pay the invoice until _*4/15*__. Record the payment assuming the purchase was recorded using the net method:

4/11: DR: Accounts Payable $1,470
*DR: Discounts Lost $30 ← $1,500 * 2% discount (this is an expense account)*
CR: Cash $1,500
(Record payment of invoice after the discount period lapsed)

g. Implied Interest Formula: [365 days / (Credit period – discount period)] * Cash Discount Rate

What would be the implied interest rate in Class Example c above?

*=[365/(30-10)] * 0.02 = 36.5%*

How does this compare to market interest rates?
MUCH HIGHER

Target could take out a 30-day loan from a bank, and pay 5% interest. Use that short-term loan to pay Jakks on the 10th day, to save $30. It would cost them $6.25 in interest expense:

*P*R*T = $1,500 * 5% * 1/12 = $6.25*

4. Purchases with returns and allowances

   a. Purchase allowances – seller grants buyer a price reduction for defective goods *(keep goods)*

   b. Class Example continued: _*10*___of the _*1,000*_ LOL Surprise units Target purchased from Jakks on _*4/1*__ are defective. Jakks grants Target a _*$10*__ allowance. What entry should Target make to record the purchase allowance?

   (Assume this happens on 4/2, before Target has paid for the goods)
   4/2 DR: Accounts Payable $10
   CR: Merchandise Inventory $10
   (Record purchase allowance for defective goods)

   c. Purchase returns – merchandise the buyer returns to the seller *(send goods back)*

      i. Recorded at the cost charged to buyer

   d. Class Example: On __*7/1*_, Nordstrom purchases _*$1,000*_ of merchandise with terms _*2/10*__, _*n30*___. On _*7/5*___, Nordstrom returns _*$200*_____ worth of that merchandise. On _*7/11*____ Nordstrom pays the remaining balance due. What entries should Nordstrom record for this transaction, assuming Nordstrom uses the **Gross** Method?

   7/1 DR: Merchandise Inventory $1,000
   CR: Accounts Payable $1,000
   (Purchased goods on account)

   7/5 DR: Accounts Payable $200
   CR: Merchandise Inventory $200
   (Returned goods to seller)

   7/11 DR: Accounts Payable $800
   *CR: Merchandise Inventory $16 ← $800 * 2%*
   *CR: Cash $784 ← $800 * 98%*
   (Paid invoice within discount period)

5. What is included in the merchandise inventory account?
   a. Purchases – at _*cost*_____ *(Cost decreases for cash discounts, returns and allowances)*

   b. Related costs: *we "capitalize" these costs (Capitalize means add it to the balance in the asset account)*

      i. T*axes*________________

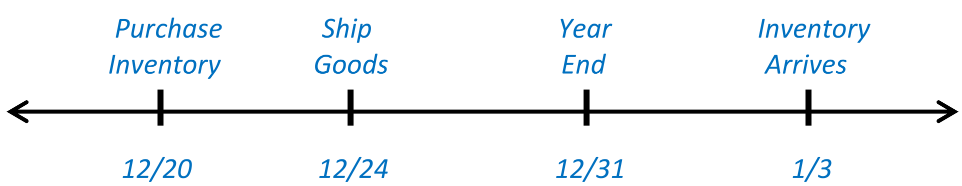
      ii. I*nsurance*__________ (ONLY if **the buyer** is insuring the goods while they are in transit)

      iii. S*torage*____________

      iv. F*reight*______________

      v. Any other costs n*ecessary*____________ to make the inventory ready for sale

   c. Inventory in transit – inventory that has left the sellers warehouse but not arrived at the buyers. Who owns the inventory?



(FOB XXXX = XXXX means where the title/ownership transfers)

      i. FOB S*hipping*__ P*oint*____= *Buyer*__ pays for shipping, *buyer*_ owns the goods at *year-end*__ ← *If goods are still in transit*

         a. B*uyer*____ capitalizes freight:

DR: Merchandise Inventory	*XX*		← *The amount paid for shipping/freight*
CR: Cash		*XX*	

      ii. FOB D*estination*_______ = *Seller*____ pays for shipping, *seller*___ owns the goods at *year-end*_____. ← *If goods are still in transit*

         a. S*eller*____ expenses freight

DR: Transportation Expense	*XX*		← *The amount paid for shipping/freight*
CR: Cash		*XX*	

C. Accounting for Sales of Merchandise Inventory *recorded in 2 parts:*

1. Revenues – how much customers paid for the merchandise

2. Costs – how much the company paid for the merchandise

3. Sales without Cash discounts:

   a. Class Example: On _*12/24*__, Samsung sold merchandise costing _*$3,000*_ to Best Buy for _*$10,000* on credit terms _*n/30*__. Samsung records:

12/24 DR: A/R – Best Buy $10,000
CR: Sales $10,000
(Sold goods on credit)

12/24 DR: COGS $3,000
CR: Inventory $3,000
(Record cost of 12/24 sale)

4. Gross Profit Margin

Net Sales	*$10,000*
Less: COGS	*($3,000)*
Gross Profit	*$7,000*

5. Sales with Cash Discounts – sellers required to report sales net of expected discounts
   a. Gross method – Record sales at gross amount; record period end adjusting entry to estimate discounts *(e.g., A: 12/31)*

   b. Net method – Record sales at net amount, assuming all discounts will be taken; record any discounts lost in later periods when loss occurs *(e.g., when payment is collected – we don't record "Discounts Lost" the next day after the discount period expires)*

   c. Class Example 3a. (continued): Assume Samsung offers Best Buy a discount on the _*12/24*__ sale of _*3/10*_, _*n/60*__. What is the entry/ies to record this sale, using the Gross method?

   SAME ENTRIES AS ABOVE
   Because they are using the Gross Method. If/when they collect payment within the discount period, the entries will be different

d. Sales Discount – Contra Sales account with a normal _*DR*___ balance *(Reduces Sales)*

e. Class Example 3a (continued): Best Buy pays the invoice on __*12/31*__. What entries should Samsung make to record the payment within the discount period?

12/31	*DR: Cash*	*$9,700*		← *($10,000 * 97%)*
	DR: Sales Discount	*$300*		← *($10,000 * 3%)*
	CR: A/R – Best Buy		*$10,000*	

(To record payment of invoice within discount period)

NO CHANGE TO COGS

f. Class Example continued: Best Buy pays the invoice on _*1/23*___. What entries should Samsung make to record the payment **after** the discount period has lapsed?

1/23	*DR: Cash*	*$10,000*	
	CR: A/R – Best Buy		*$10,000*

(To record payment of invoice after discount period has lapsed)

6. Sales with Returns and Allowances
   a. Sales return – *buyer returns inventory/seller gets inventory back; seller issues full refund*

   b. Sales allowance – *buyer keeps goods/seller does not get inventory back; seller issues partial refund*

   c. Sales Returns and Allowances – Contra Sales account, normal _*DR*_ balance *(Reduces sales) Works just like Sales Discount account*

   d. Class Example continued: On _*2/1*_, Best Buy returns merchandise that was purchased for _*$1,000*_ and cost Samsung _*$300*__. The merchandise was not defective. What entry/ies should Samsung record? *(Remember, Best Buy ALREADY PAID the invoice on 1/23)*

      2/1 DR: Sales Returns and Allowances $1,000
      CR: Cash $1,000 ← b/c Best Buy already paid
      -AND-
      DR: Merchandise Inventory $300 ← b/c Best Buy got the inventory back
      CR: COGS $300
      (Goods returned for refund from 12/24 sale)

   e. Class Example continued: Assume the merchandise returned in the above example was defective, and is now estimated to be worth __*$70*__. What entry should Samsung make to record the return of the defective goods?

      FIRST ENTRY IS THE SAME

      2/1 DR: Merchandise Inventory $70 ← the value of the inventory
      DR: Loss from defective merchandise $230
      CR: COGS $300
      (Goods returned for refund from 12/24 sale)

   f. Class Example continued: Assume that rather than return the defective merchandise, Samsung offers a _*$100*___price reduction paid in cash to Best Buy, and Best Buy decides to keep the defective merchandise. What entry/ies should Samsung record?

      2/1 DR: Sales Returns and Allowances $100
      CR: Cash $100 ← b/c Best Buy already paid

      NO SECOND ENTRY, BECAUSE BEST BUY KEEPS THE INVENTORY

D. Reporting

1. Adjusting entries

a. Inventory shrinkage *– means loss of inventory. Due to (1) theft (2) deterioration*

i. Applies when using perpetual inventory system

ii. Calculated by comparing a physical count (performed annually) with general ledger

iii. Class Example: Target's inventory account at year-end has a balance of _*$500,000*__.

The physical count reveals that only _*$475,000*___ of inventory exists. What adjusting entry should Target record to reconcile the ending inventory to the physical count?

A: 12/31 DR: COGS $25,000 ← ($500,000 - $475,000)
CR: Inventory $25,000
(Reconcile ending inventory to physical count)

A merchandiser hates to record this entry. It directly reduces net income for the entire amount of the lost inventory

b. Sales Discounts - reflect discounts expected to be taken on sales already made at year-end *(Only applies/necessary if the seller records sales using the Gross Method)*

i. Allowance for Sales Discounts = Contra Asset account, reduces Accounts Receivable

ii. Class Example: Jakks Pacific has a receivable from Target of __*$10,000*___ as of _*12/31*_. Of this receivable, _*$2,000*___ is within the _*2%*__ discount period, and historically Target has paid within the discount period. What adjusting entry should Jakks record to reflect the most likely estimate of Sales Discounts?

*A: 12/31 DR: Sales Discounts $40 ← ($2,000 * 2%)*
CR: Allowance for Sales Discounts $40

(Adjustment for future discounts expected to be taken)

c. Sales Returns and Allowances *(again – 2 parts to record)*

i. New asset account – Inventory Returns (estimated) *we ONLY update this account during the period-end adjusting process*

ii. New liability account – Sales Refund payable (estimated)

iii. Class Example: On _*12/31*_, Samsung estimates future sales refunds to be _*$12,000*__.

The unadjusted balance in the sales refund payable account is __*$3,000*__. What adjusting entry should Samsung record?

A: 12/31	*DR: Sales Returns and Allowances*	*$9,000*	*← $12,000 - $3,000*
	CR: Sales Refunds Payable		*$9,000*
	(Expected refund of sales)		

iv. Class Example continued: The cost of merchandise expected to be returned is *$5,000*

and the unadjusted balance in the inventory returns account is __*$2,000*___.

What adjusting entry should Samsung record?

A: 12/31	*DR: Inventory Returns – estimated*	*$3,000*	*← $5,000 - $2,000*
	CR: COGS		*$3,000*
	(Expected return of inventory)		

2. Closing entries

   a. Temporary Accounts: *Close to Income Summary*

      S*ales*_____ ← *Normal CR Balance; close with a DR to sales, CR to Income Summary*

      S*ales*_ D*iscounts*_ ← *Normal DR Balance; close with a CR to Sales Discount, DR to Income Summary*

      S*ales*_ R*eturns*_ and A*llowances*_ ← *Normal DR Balance; close with a CR to Sales Returns and Allowances, DR to Income Summary*

      C*ost*_ of G*oods*_ S*old*_ ← *Normal DR Balance; close with a CR to COGS, DR to Income Summary*

   b. Closing the temporary accounts – first 2 entries are slightly different, rest of the entries are the same

DR: Sales	*XX*	*DR: Income Summary*	*XX*
CR: Income Summary	*XX*	*CR: Sales Discounts*	*XX*
		CR: Sales R&A	*XX*
		CR: COGS	*XX*

3. Preparing financial statements
   a. Multiple-step Income Statement – shows detailed computations of net sales and other costs

      i. Gross profit = N*et*_ S*ales*_ – C*OGS*_

         Sales

         Less: Sales Discounts

         Less: Sales Returns and Allowances

         Net Sales

      ii. Income from operations = Gross profit – O*perating*_ e*xpenses*_

         Operating expenses classified into 2 sections:

         1) S*elling*_ expenses *(Advertising, Commissions)*

         2) G*eneral*_ and a*dministrative*_ expenses *(HR, Accounting, Legal)*

         Some expenses are allocated between both categories (i.e., rent, salaries)

      iii. Net Income = Income from operations – n*on*_-o*perating*_ i*tems*_ *(i.e., interest income and expense, dividend income)*