5 Accounting for Merchandising Operations

Learning Objectives

1. Describe merchandising operations and inventory systems.
2. Record purchases under a perpetual inventory system.
3. Record sales under a perpetual inventory system.
4. Apply the steps in the accounting cycle to a merchandising company.
5. Compare a multiple-step with a single-step income statement.

LEARNING OBJECTIVE 1

Describe merchandising operations and inventory systems.

Merchandising Companies

Buy and Sell Goods

Retailer

Wholesaler

Consumer

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

Merchandising Operations

Income Measurement

Sales Revenue

Less

Cost of Goods Sold

Equals

Gross Profit

Less

Operating Expenses

Equals

Net Income (Loss)

Not used in a Service business.

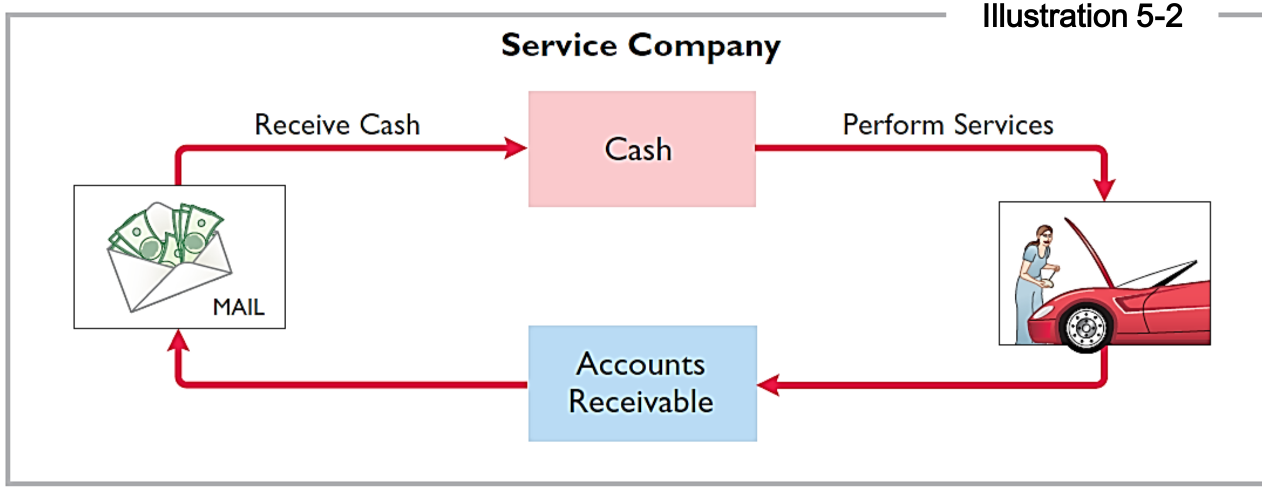
Illustration 5-1
Income measurement process for a merchandising company

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

Operating Cycles

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

Illustration 5-2



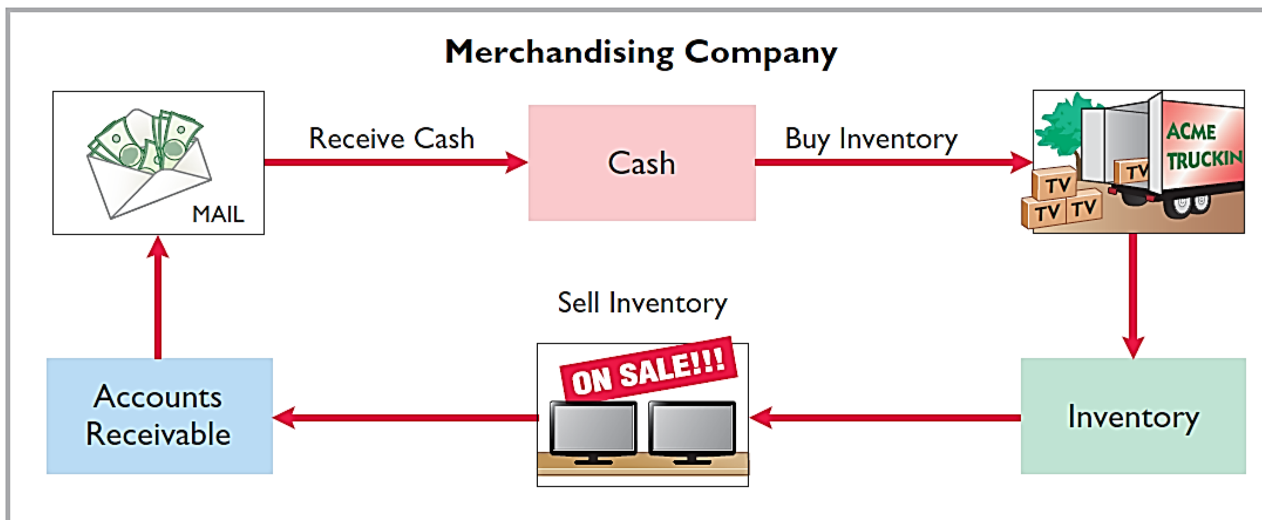
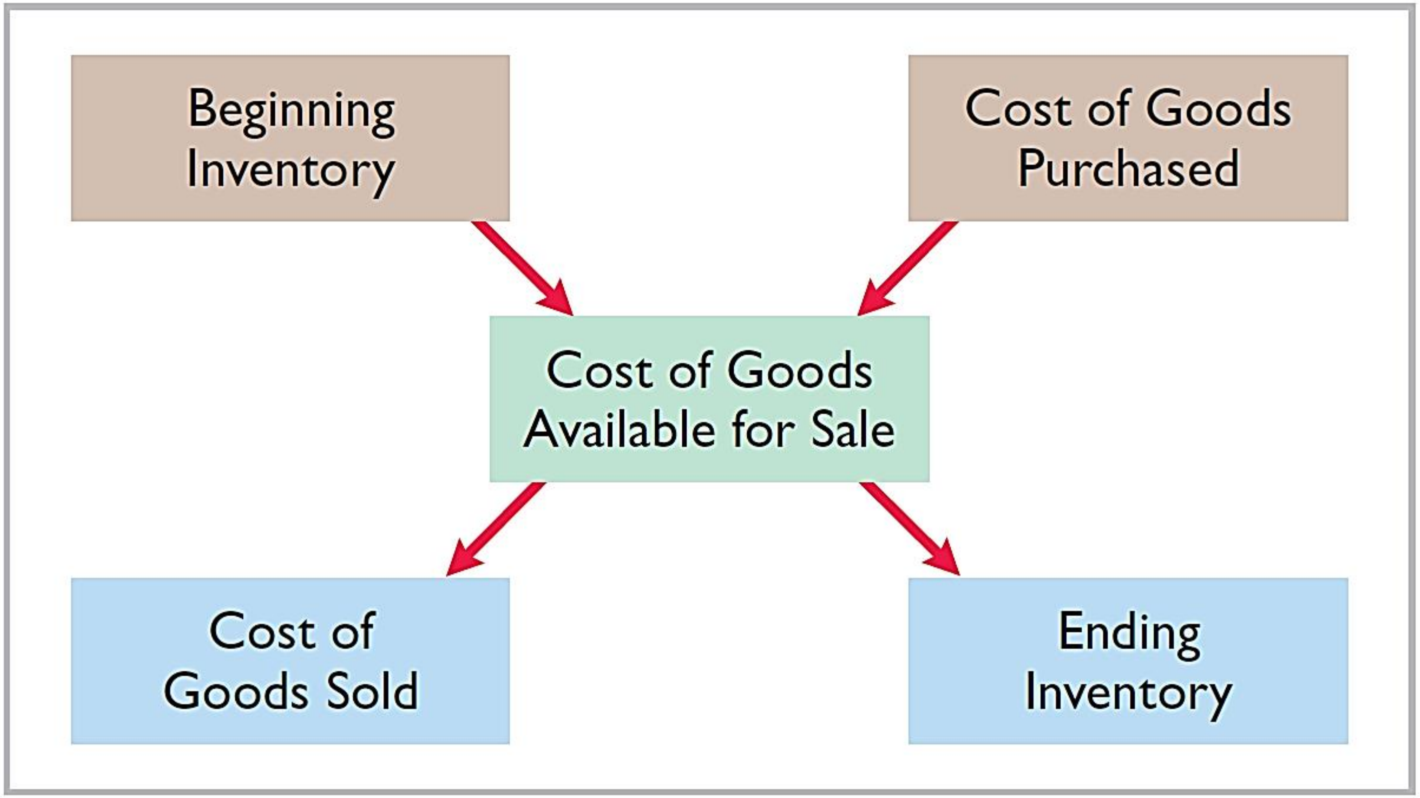


Illustration 5-3

Flow of Costs

Illustration 5-4



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

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.

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	900,000
Less: Ending inventory	125,000
Cost of goods sold	$ 775,000

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.

Investor Insight

Morrow Snowboards Improves Its Stock Appeal

Investors are often eager to invest in a company that has a hot new product. However, when snowboard-maker Morrow Snowboards, Inc. issued shares of stock to the public for the first time, some investors expressed reluctance to invest in Morrow because of a number of accounting control problems.

To reduce investor concerns, Morrow 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.

If a perpetual system keeps track of inventory on a daily basis, why do companies ever need to do a physical count? (Go to **WileyPLUS** for this answer and additional questions.)

DO IT! 1

Merchandising Operations and Inventory Systems

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. **False**

2. The operating cycle of a service company is usually shorter than that of a merchandising company. **True**

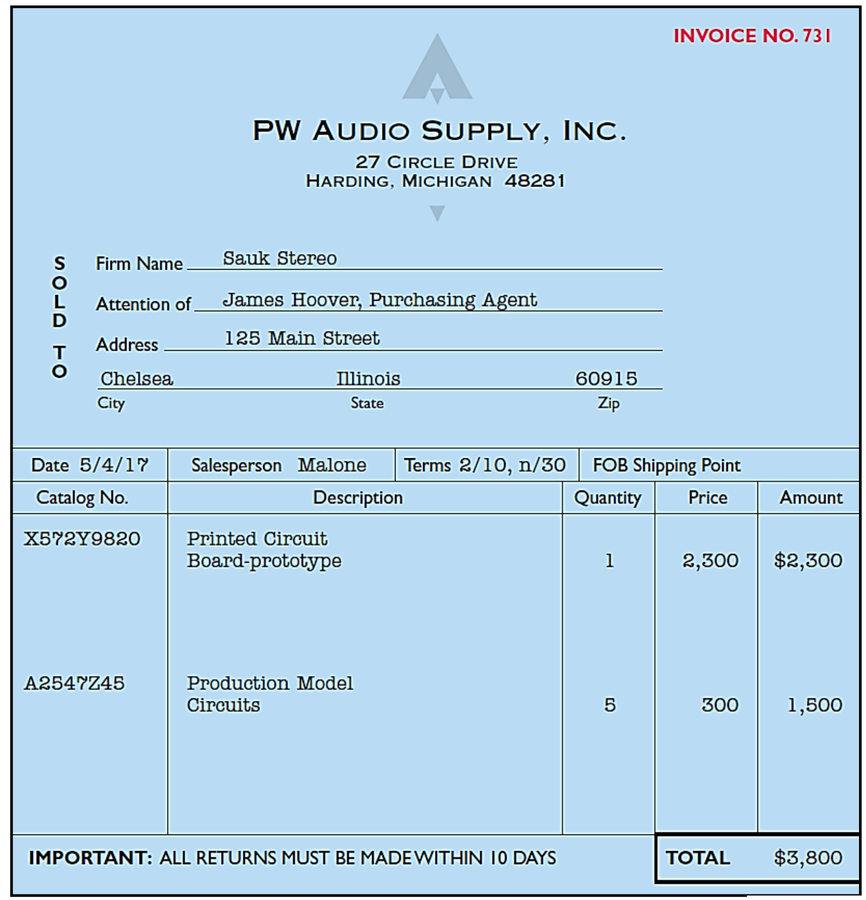
3. Sales revenue less cost of goods sold equals gross profit. **True**

4. Ending inventory plus the cost of goods purchased equals cost of goods available for sale. **False**

LEARNING OBJECTIVE 2

Record purchases under a perpetual inventory system.

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



INVOICE NO. 731

PW AUDIO SUPPLY, INC.
27 CIRCLE DRIVE
HARDING, MICHIGAN 48281

SOLD TO
Firm Name: Sauk Stereo
Attention of: James Hoover, Purchasing Agent
Address: 125 Main Street
City: Chelsea State: Illinois Zip: 60915

Date 5/4/17	Salesperson Malone	Terms 2/10, n/30	FOB Shipping Point	
Catalog No.	**Description**	**Quantity**	**Price**	**Amount**
X572Y9820	Printed Circuit Board-prototype	1	2,300	$2,300
A2547Z45	Production Model Circuits	5	300	1,500
			TOTAL	$3,800

IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS

Illustration 5-6
Sales invoice used as purchase invoice by Sauk Stereo

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.

Illustration 5-6

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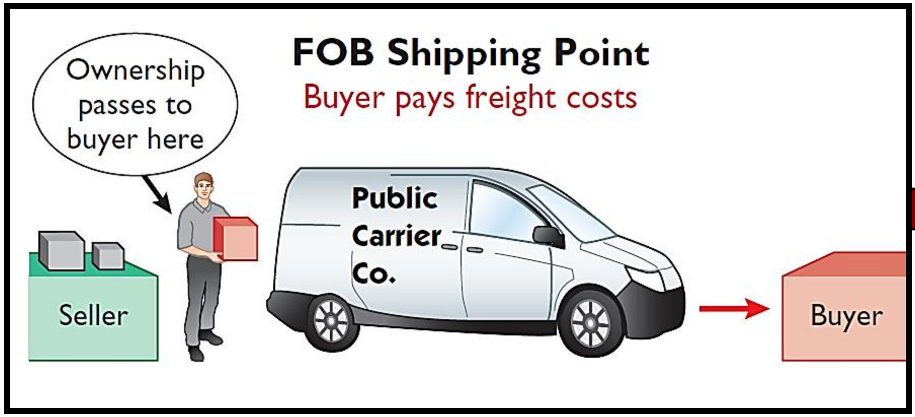
			TOTAL	$3,800

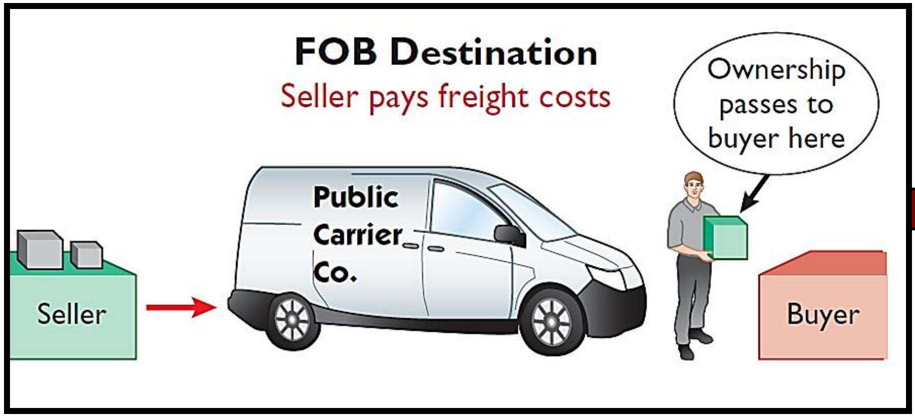
IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS

May 4	Inventory	3,800	
	Accounts Payable		3,800

Freight Costs



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



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

Illustration 5-7
Shipping terms

Freight costs incurred by the seller are an **operating expense**.

Freight Costs

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

May 6	Inventory	150	
	Cash		150

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

May 4	Freight-Out	150	
	Cash		150

Purchase Returns and Allowances

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

Purchase Return	Purchase Allowance
Return goods for credit if the sale was made on credit, or for a cash refund if the purchase was for cash.	May choose to keep the merchandise if the seller will grant a reduction of the purchase price.

Purchase Returns and Allowances

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

May 8	Accounts Payable	300	
	Inventory		300

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

Purchase Discounts

Credit terms may permit buyer to claim a cash discount for prompt payment.

Advantages:

Example: Credit terms may read **2/10, n/30**.

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

Purchase Discounts

2/10, n/30	1/10 EOM	n/10 EOM
2% discount if paid within 10 days, otherwise net amount due within 30 days.	1% discount if paid within first 10 days of next month.	Net amount due within the first 10 days of the next month.

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 last day of the discount period. Prepare the journal entry Sauk Stereo makes on May 14 to record the payment.

May 14	Accounts Payable	3,500	
	Inventory		70
	Cash		3,430

(Discount = $3,500 x 2% = **$70**)

Purchase Discounts

Illustration: If Sauk Stereo failed to take the discount, and instead made full payment of $3,500 on June 3, the journal entry would be:

June 3	Accounts Payable	3,500	
	Cash		3,500

Purchase Discounts

Should discounts be taken when offered?

Discount of 2% on \$3,500	\$	70.00
\$3,500 invested at 10% for 20 days		19.18
Savings by taking the discount	**\$**	**50.82**

Example: 2% for 20 days = Annual rate of 36.5%

\$3,500 x 36.5% x 20 ÷ 365 = \$70

Summary of Purchasing Transactions

Inventory

	Debit	**Credit**	
4th - Purchase	3,800	300	8th - Return
6th – Freight-in	150	70	14th - Discount
Balance	3,580		

DO IT! 2 Purchase Transactions

On September 5, De La Hoya Company buys merchandise on account from Junot Diaz Company. The selling price of the goods is $1,500, and the cost to Diaz Company was $800. On September 8, De La Hoya returns defective goods with a selling price of $200. Record the transactions on the books of De La Hoya Company.

Sept. 5	Inventory	1,500	
	Accounts Payable		1,500
Sept. 8	Accounts Payable	200	
	Inventory		200

LEARNING OBJECTIVE 3

Record sales under a perpetual inventory system.

- 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.

Illustration 5-6

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			TOTAL	$3,800

IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS

Recording Sales of Merchandise

Journal Entries to Record a Sale

#1	Cash **or** Accounts receivable	XXX		Selling Price
	Sales revenue		XXX	
#2	Cost of goods sold	XXX		Cost
	Inventory		XXX	

Recording Sales of Merchandise

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).

May 4	Accounts Receivable	3,800	
	Sales Revenue		3,800
4	Cost of Goods Sold	2,400	
	Inventory		2,400

ANATOMY OF A FRAUD[1]

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

Source: Adapted from Wells, *Fraud Casebook* (2007), pp. 251–259.

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.

Sales Returns and Allowances

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). Assume the **goods were not defective**.

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
8	Inventory	140	
	Cost of Goods Sold		140

Sales Returns and Allowances

Illustration: Assume the **returned goods were defective** and had a scrap value of $50, PW Audio would make the following entries:

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
8	Inventory	50	
	Cost of Goods Sold		50

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.

Accounting Across the Organization

Should Costco Change Its Return Policy?

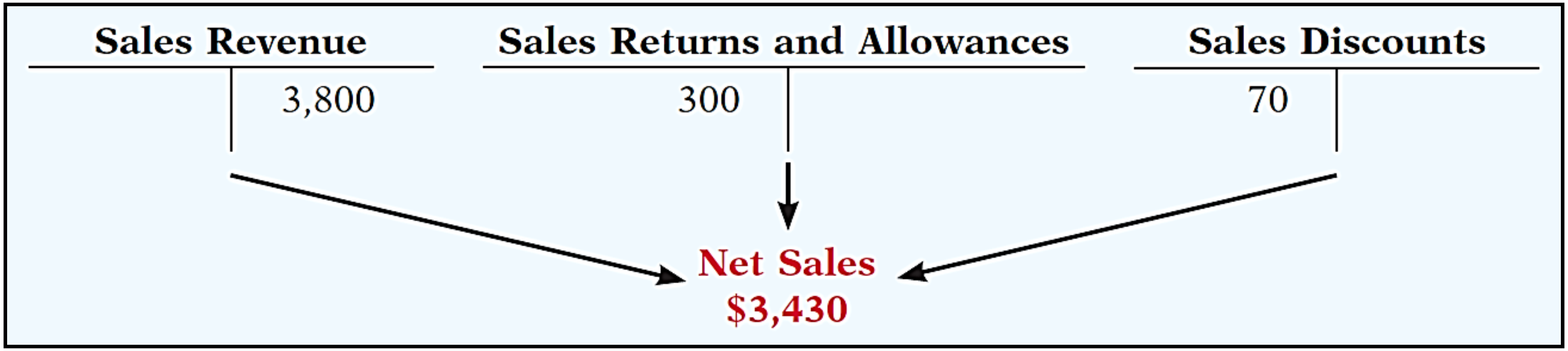
In most industries, sales returns are relatively minor. But returns of consumer electronics can really take a bite out of profits. Recently, the marketing executives at Costco Wholesale Corp. faced a difficult decision. Costco has always prided itself on its generous return policy. Most goods have had an unlimited grace period for returns. However, a new policy requires that certain electronics must be returned within 90 days of their purchase. The reason? The cost of returned products such as high-definition TVs, computers, and iPods cut an estimated 8¢ per share off Costco's earnings per share, which was $2.30.

Source: Kris Hudson, "Costco Tightens Policy on Returning Electronics," *Wall Street Journal* (February 27, 2007), p. B4.

If a company expects significant returns, what are the implications for revenue recognition? (Go to **WileyPLUS** for this answer and additional questions.)

Sales Discount

- Offered to customers to **promote prompt payment** of the balance due.
- **Contra-revenue account** (debit) to Sales Revenue.



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, the last day of the discount period. Prepare the journal entry PW Audio Supply makes to record the receipt on May 14.

May 14	Cash	3,430	
	Sales Discounts	70 *	
	Accounts Receivable		3,500

* [($3,800 – $300) X 2%]

DO IT! 3 Sales Transactions

On September 5, De La Hoya Company buys merchandise on account from Junot Diaz Company. The selling price of the goods is $1,500, and the cost to Diaz Company was $800. On September 8, De La Hoya returns defective goods with a selling price of $200 and a fair value of $30. Record the transactions on the books of Junot Diaz Company.

Sept. 5	Accounts Receivable	1,500	
	Sales Revenue		1,500
Sept. 5	Cost of Goods Sold	800	
	Inventory		800

DO IT! 3 Sales Transactions

On September 5, De La Hoya Company buys merchandise on account from Junot Diaz Company. The selling price of the goods is $1,500, and the cost to Diaz Company was $800. On September 8, De La Hoya returns defective goods with a selling price of $200 and a fair value of $30. Record the transactions on the books of Junot Diaz Company.

Sept. 8	Sales Returns and Allowances	200	
	Accounts Receivable		200
Sept. 8	Inventory	30	
	Cost of Goods Sold		30

LEARNING OBJECTIVE 4

Apply the steps in the accounting cycle to a merchandising company.

Adjusting Entries

- Generally the same as a service company.
- One additional adjustment to make the records agree with the actual inventory on hand.
- Involves adjusting Inventory and Cost of Goods Sold.

Adjusting Entries

Illustration: Suppose that PW Audio Supply has an unadjusted balance of $40,500 in Merchandise Inventory. Through a physical count, PW Audio determines that its actual merchandise inventory at year-end is $40,000. The company would make an adjusting entry as follows.

Cost of Goods Sold	500	
Inventory		500

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

Closing Entries

31	Income Summary	30,000	
	Owner's Capital		30,000
	(To transfer net income to capital)		
31	Owner's Capital	15,000	
	Owner's Drawings		15,000
	(To close drawings to capital)		

DO IT! 4 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.

Dec. 31	Sales Revenue	162,400	
	Rent Revenue	6,000	
	Income Summary		168,400

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.

Dec. 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

LEARNING OBJECTIVE 5

Compare a multiple-step with a single-step income statement.

Multiple-Step Income Statement

- Shows several steps in determining net income.
- Two steps relate to principal operating activities.
- Distinguishes between operating and non-operating activities.

Multiple-Step

Key Items:

- Net sales

PW AUDIO SUPPLY 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 revenues and gains		
Interest revenue	3,000	
Gain on disposal of plant assets	600	3,600
Other expenses and losses		
Interest expense	1,800	
Casualty loss from vandalism	200	2,000
Net income		$ 31,600

Illustration 5-14

Multiple-Step

Key Items:

- Net sales
- Gross profit

Illustration 5-14

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Multiple-Step

Key Items:

- Net sales
- Gross profit
- Operating expenses

Illustration 5-14

PW AUDIO SUPPLY
Income Statement
For the Year Ended December 31, 2017

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Multiple-Step

Key Items:

- Net sales
- Gross profit
- Operating expenses
- **Nonoperating activities**

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Net income		$ 31,600

Illustration 5-14

Multiple-Step

Key Items:

- Net sales
- Gross profit
- Operating expenses
- Nonoperating activities

Illustration 5-14

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Income Statement
For the Year Ended December 31, 2017

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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

Other Revenues and Gains

Interest revenue from notes receivable and marketable securities.
Dividend revenue from investments in capital stock.
Rent revenue from subleasing a portion of the store.
Gain from the sale of property, plant, and equipment.

Other Expenses and Losses

Interest expense on notes and loans payable.
Casualty losses from recurring causes, such as vandalism and accidents.
Loss from the sale or abandonment of property, plant, and equipment.
Loss from strikes by employees and suppliers.

Multiple-Step

Key Items:

- Net sales
- Gross profit
- Operating expenses
- Nonoperating activities
- Net income

PW AUDIO SUPPLY
Income Statement
For the Year Ended December 31, 2017

Sales		
Sales revenue		$480,000
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Freight-out	7,000	
Insurance expense	2,000	
Total operating expenses		114,000
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Interest revenue	3,000	
Gain on disposal of plant assets	600	3,600
Other expenses and losses		
Interest expense	1,800	
Casualty loss from vandalism	200	2,000
Net income		$ 31,600

Illustration 5-14

Multiple-Step Income Statement

Question

The multiple-step income statement for a merchandiser shows each of the following features except:

a. gross profit.

b. cost of goods sold.

c. a sales revenue section.

d. investing activities section.

Ethics Insight IBM

Disclosing More Details

After Enron, increased investor criticism and regulator scrutiny forced many companies to improve the clarity of their financial disclosures. For example, IBM began providing more detail regarding its "Other gains and losses." It had previously included these items in its selling, general, and administrative expenses, with little disclosure. For example, previously if IBM sold off one of its buildings at a gain, it would include this gain in the selling, general and administrative expense line item, thus reducing that expense. This made it appear that the company had done a better job of controlling operating expenses than it actually had.

As another example, when eBay sold the remainder of its investment in Skype to Microsoft, it reported a gain in "Other revenues and gains" of $1.7 billion. Since eBay's total income from operations was $2.4 billion, it was very important that the gain from the Skype sale not be buried in operating income.

Why have investors and analysts demanded more accuracy in isolating "Other gains and losses" from operating items? (Go to **WileyPLUS** for this answer and additional questions.)

Single-Step Income Statement

- Subtract total expenses from total revenues
- Two reasons for using the single-step format:
  1. Company does not realize any profit until total revenues exceed total expenses.
  2. Format is simpler and easier to read.

Single-Step Income Statement

Illustration 5-15

PW AUDIO SUPPLY Income Statement For the Year Ended December 31, 2017		
Revenues		
Net sales		$460,000
Interest revenue		3,000
Gain on disposal of plant assets		600
Total revenues		463,600
Expenses		
Cost of goods sold	$316,000	
Operating expenses	114,000	
Interest expense	1,800	
Casualty loss from vandalism	200	
Total expenses		432,000
Net income		$ 31,600

Classified Balance Sheet

Illustration 5-16

PW AUDIO SUPPLY
Balance Sheet (Partial)
December 31, 2017

Assets		
Current assets		
Cash		$ 9,500
Accounts receivable		16,100
Inventory		40,000
Prepaid insurance		1,800
Total current assets		67,400
Property, plant, and equipment		
Equipment	$80,000	
Less: Accumulated depreciation—equipment	24,000	56,000
Total assets		$123,400

DO IT! 5 Financial Statement Classifications

Indicate in which financial statement and under what classification each of the following accounts would be reported.

Account	Financial Statement	Classification
Accounts Payable		
Accounts Receivable		
Accumulated Depreciation—Buildings		
Accumulated Depreciation—Equipment		
Advertising Expense		
Buildings		
Cash		

Account	Financial Statement	Classification
Depreciation Expense		
Equipment		
Freight-Out		
Gain on Disposal of Plant Assets		
Insurance Expense		
Interest Expense		
Interest Payable		
Inventory		
Land		
Notes Payable (due in 3 years)		

Account	Financial Statement	Classification
Owner's Capital	Owner's equity statement	Beginning balance
Owner's Drawings	Owner's equity statement	Deduction section
Property Taxes Payable	Balance sheet	Current liabilities
Salaries and Wages Expense	Income statement	Operating expenses
Salaries and Wages Payable	Balance sheet	Current liabilities
Sales Returns and Allowances	Income statement	Sales
Sales Revenue	Income statement	Sales
Utilities Expense	Income statement	Operating expenses

LO 5

LEARNING OBJECTIVE 6

APPENDIX 5A: Prepare a worksheet for a merchandising company.

Using a Worksheet

As indicated in Chapter 4, a worksheet enables companies to prepare financial statements before they journalize and post adjusting entries. The steps in preparing a worksheet for a merchandising company are the same as for a service company. Illustration 5A-1 shows the worksheet for PW Audio Supply, Inc. (excluding nonoperating items). The unique accounts for a merchandiser using a **perpetual inventory system** are in red.

Illustration 5A-1

PW AUDIO SUPPLY
Worksheet
For the Year Ended December 31, 2017

Accounts	Trial Balance Dr.	Trial Balance Cr.	Adjustments Dr.	Adjustments Cr.	Adjusted Trial Balance Dr.	Adjusted Trial Balance Cr.	Income Statement Dr.	Income Statement Cr.	Balance Sheet Dr.	Balance Sheet Cr.
Cash	9,500				9,500				9,500	
Accounts Receivable	16,100				16,100				16,100	
Inventory	40,500			(a) 500	40,000				40,000	
Prepaid Insurance	3,800			(b) 2,000	1,800				1,800	
Equipment	80,000				80,000				80,000	
Accumulated Depreciation—Equipment		16,000		(c) 8,000		24,000				24,000
Accounts Payable		20,400				20,400				20,400
Owner's Capital		83,000				83,000				83,000
Owner's Drawings	15,000				15,000				15,000	
Sales Revenue		480,000				480,000		480,000		
Sales Returns and Allowances	12,000				12,000		12,000			
Sales Discounts	8,000				8,000		8,000			
Cost of Goods Sold	315,500		(a) 500		316,000		316,000			
Freight-Out	7,000				7,000		7,000			
Advertising Expense	16,000				16,000		16,000			
Salaries and Wages Expense	59,000		(d) 5,000		64,000		64,000			
Utilities Expense	17,000				17,000		17,000			
Totals	599,400	599,400								
Insurance Expense			(b) 2,000		2,000		2,000			
Depreciation Expense			(c) 8,000		8,000		8,000			
Salaries and Wages Payable				(d) 5,000		5,000				5,000
Totals			15,500	15,500	612,400	612,400	450,000	480,000	162,400	132,400
Net Income							30,000			30,000
Totals							480,000	480,000	162,400	162,400

LO 6

Determining Cost of Goods Sold Under a Periodic System

- No running account of changes in inventory.
- Ending inventory determined by physical count.
- Cost of goods sold not determined until the end of the period.

Determining Cost of Goods Sold Under a Periodic System

Illustration 5B-2
Cost of goods sold for a merchandiser using a periodic inventory system

PW AUDIO SUPPLY Cost of Goods Sold For the Year Ended December 31, 2017			
Cost of goods sold			
Inventory, January 1			**$ 36,000**
Purchases		$325,000	
Less: Purchase returns and allowances	$10,400		
Purchase discounts	6,800	17,200	
Net purchases		307,800	
Add: Freight-in		12,200	
Cost of goods purchased			**320,000**
Cost of goods available for sale			356,000
Less: Inventory, December 31			**40,000**
Cost of goods sold			**$316,000**

 LO 7

Recording Merchandise Transactions

- Record revenues when sales are made.
- Do not record cost of merchandise sold on the date of sale.
- Physical inventory count determines:
  - Cost of merchandise **on hand** and
  - Cost of merchandise **sold** during the period.
- Record purchases in Purchases account.
- Purchase returns and allowances, Purchase discounts, and Freight costs are recorded in separate accounts.

Recording Purchases of Merchandise

Illustration: On the basis of the sales invoice (Illustration 5-6) and receipt of the merchandise ordered from PW Audio Supply, Sauk Stereo records the $3,800 purchase as follows.

May 4	Purchases	3,800	
	Accounts Payable		3,800

Recording Purchases of Merchandise

FREIGHT COSTS

Illustration: If Sauk pays Public Freight Company $150 for freight charges on its purchase from PW Audio Supply on May 6, the entry on Sauk's books is:

May 6	Freight-In (Transportation-In)	150	
	Cash		150

Recording Purchases of Merchandise

PURCHASE RETURNS AND ALLOWANCES

Illustration: Sauk Stereo returns $300 of goods to PW Audio Supply and prepares the following entry to recognize the return.

May 8	Accounts payable	300	
	Purchase Returns and Allowances		300

Recording Purchases of Merchandise

PURCHASE DISCOUNTS

Illustration: On May 14 Sauk Stereo pays the balance due on account to PW Audio Supply, taking the 2% cash discount allowed by PW Audio for payment within 10 days. Sauk Stereo records the payment and discount as follows.

May 14	Accounts Payable	3,500	
	Purchase Discounts		70
	Cash		3,430

Recording Sales of Merchandise

Illustration: PW Audio Supply, records the sale of $3,800 of merchandise to Sauk Stereo on May 4 (sales invoice No. 731, Illustration 5-6) as follows.

May 4	Accounts Receivable	3,800	
	Sales Revenue		3,800

No entry is recorded for cost of goods sold at the time of the sale under a periodic system.

Recording Sales of Merchandise

SALES RETURNS AND ALLOWANCES

Illustration: To record the returned goods received from Sauk Stereo on May 8, PW Audio Supply records the $300 sales return as follows.

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300

Recording Sales of Merchandise

SALES DISCOUNTS

Illustration: On May 14, PW Audio Supply receives payment of $3,430 on account from Sauk Stereo. PW Audio honors the 2% cash discount and records the payment of Sauk's account receivable in full as follows.

May 14	Cash	3,430	
	Sales Discounts	70	
	Accounts Receivable		3,500

Recording Sales of Merchandise

COMPARISON OF ENTRIES

Illustration 5B-3

ENTRIES ON SAUK STEREO'S BOOKS

Transaction		Perpetual Inventory System			Periodic Inventory System		
May 4	Purchase of merchandise on credit.	**Inventory**	**3,800**		**Purchases**	**3,800**	
		Accounts Payable		3,800	Accounts Payable		3,800
6	Freight costs on purchases.	**Inventory**	**150**		**Freight-In**	**150**	
		Cash		150	Cash		150
8	Purchase returns and allowances.	Accounts Payable	300		Accounts Payable	300	
		Inventory		**300**	**Purchase Returns and Allowances**		**300**
14	Payment on account with a discount.	Accounts Payable	3,500		Accounts Payable	3,500	
		Cash		3,430	Cash		3,430
		Inventory		**70**	**Purchase Discounts**		**70**

Recording Sales of Merchandise

COMPARISON OF ENTRIES

Illustration 5B-3

ENTRIES ON PW AUDIO SUPPLY'S BOOKS

Transaction		Perpetual Inventory System			Periodic Inventory System		
May 4	Sale of merchandise on credit.	Accounts Receivable	3,800		Accounts Receivable	3,800	
		Sales Revenue		3,800	Sales Revenue		3,800
		Cost of Goods Sold	**2,400**		**No entry for cost of goods sold**		
		Inventory		**2,400**			
8	Return of merchandise sold.	Sales Returns and Allowances	300		Sales Returns and Allowances	300	
		Accounts Receivable		300	Accounts Receivable		300
		Inventory	**140**		**No entry**		
		Cost of Goods Sold		**140**			
14	Cash received on account with a discount.	Cash	3,430		Cash	3,430	
		Sales Discounts	70		Sales Discounts	70	
		Accounts Receivable		3,500	Accounts Receivable		3,500

Illustration 5B-5
Worksheet for merchandising company—periodic inventory system

PW AUDIO SUPPLY
Worksheet
For the Year Ended December 31, 2017

	A	B	C	D	E	F	G	H	I	J	K
5–6		Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
7	Accounts	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
8	Cash	9,500				9,500				9,500	
9	Accounts Receivable	16,100				16,100				16,100	
10	INVENTORY	36,000				36,000		36,000	40,000	40,000	
11	Prepaid Insurance	3,800			(a) 2,000	1,800				1,800	
12	Equipment	80,000				80,000				80,000	
13	Accumulated Depreciation—Equipment		16,000		(b) 8,000		24,000				24,000
14	Accounts Payable		20,400				20,400				20,400
15	Owner's Capital		83,000				83,000				83,000
16	Owner's Drawings	15,000				15,000				15,000	
17	SALES REVENUE		480,000				480,000		480,000		
18	SALES RETURNS AND ALLOWANCES	12,000				12,000		12,000			
19	SALES DISCOUNTS	8,000				8,000		8,000			
20	PURCHASES	325,000				325,000		325,000			
21	PURCHASE RETURNS AND ALLOWANCES		10,400				10,400		10,400		
22	PURCHASE DISCOUNTS		6,800				6,800		6,800		
23	FREIGHT-IN	12,200				12,200		12,200			
24	Freight-Out	7,000				7,000		7,000			
25	Advertising Expense	16,000				16,000		16,000			
26	Salaries and Wages Expense	59,000		(c) 5,000		64,000		64,000			
27	Utilities Expense	17,000				17,000		17,000			
28	Totals	616,600	616,600								
29	Insurance Expense			(a) 2,000		2,000		2,000			
30	Depreciation Expense			(b) 8,000		8,000		8,000			
31	Salaries and Wages Payable				(c) 5,000		5,000				5,000
32	Totals			15,000	15,000	629,600	629,600	507,200	537,200	162,400	132,400
33	Net Income							30,000			30,000
34	Totals							537,200	537,200	162,400	162,400

A Look at IFRS

LEARNING OBJECTIVE 8

Compare the accounting for merchandising under GAAP and IFRS.

Key Points

Similarities

- Under both GAAP and IFRS, a company can choose to use either a perpetual or a periodic inventory system.
- The definition of inventories is basically the same under GAAP and IFRS.
- As indicated above, the basic accounting entries for merchandising are the same under both GAAP and IFRS.

A Look at IFRS

Key Points

Similarities

- IFRS requires that 2 years of income statement information be presented, whereas GAAP requires 3 years.

Differences

- Under GAAP, companies generally classify income statement items by function. Classification by function leads to descriptions like administration, distribution, and manufacturing. Under IFRS, companies must classify expenses either by nature or by function. Classification by nature leads to descriptions such as the following: salaries, depreciation expense, and utilities expense. If a company uses the functional-expense method on the income statement, disclosure by nature is required in the notes.

A Look at IFRS

Key Points

Differences

- Presentation of the income statement under GAAP follows either a single-step or multiple-step format. IFRS does not mention a single-step or multiple-step approach.
- Under IFRS, revaluation of land, buildings, and intangible assets is permitted. The initial gains and losses resulting from this revaluation are reported as adjustments to equity, often referred to as **other comprehensive income** . The effect of this difference is that the use of IFRS result in more transactions affecting equity (other comprehensive income) but not net income.

Looking to the Future

The IASB and FASB are working on a project that would rework the structure of financial statements. Specifically, this project will address the issue of how to classify various items in the income statement. A main goal of this new approach is to provide information that better represents how businesses are run. In addition, this approach draws attention away from just one number—net income. It will adopt major groupings similar to those currently used by the statement of cash flows (operating, investing, and financing), so that numbers can be more readily traced across statements. For example, the amount of income that is generated by operations would be traceable to the assets and liabilities used to generate the income. Finally, this approach would also provide detail, beyond that currently seen in most statements (either GAAP or IFRS), by requiring that line items be presented both by function and by nature. The new financial statement format was heavily influenced by suggestions from financial statement analysts.

A Look at IFRS

IFRS Self-Test Questions

Which of the following would not be included in the definition of inventory under IFRS?

a) Photocopy paper held for sale by an office-supply store.

b) Stereo equipment held for sale by an electronics store.

c) Used office equipment held for sale by the human relations department of a plastics company.

d) All of the above would meet the definition.

A Look at IFRS

IFRS Self-Test Questions

Which of the following would not be a line item of a company reporting costs by nature?

a) Depreciation expense.

b) Salaries expense.

c) Interest expense.

d) Manufacturing expense.

A Look at IFRS

IFRS Self-Test Questions

Which of the following would not be a line item of a company reporting costs by function?

a) Administration.

b) Manufacturing.

c) Utilities expense.

d) Distribution.

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