CHAPTER 6

Accounting for Merchandising Businesses

Accounting 27e

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Nature of the Merchandising Businesses

- The activities of a service business differ from those of a merchandising business.
  - These differences are reflected in the operating cycles of a service and merchandising business as well as in their financial statements.

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Operating Cycle

- The **operating cycle** is the process by which a company spends cash, generates revenues, and receives cash either at the time the revenues are generated or later by collecting an accounts receivable.
- The operating cycle of a service and merchandising business differs in that a merchandising business must purchase merchandise for sale to customers.
- The time in days to complete an operating cycle differs significantly among merchandise businesses.
  - For example, many grocery items, such as milk, must be sold within their expiration dates of a week or two.
  - In contrast, jewelry stores often carry expensive items that are often displayed months before being sold to customers.

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Financial Statements

- The differences between service and merchandising businesses are also reflected in their financial statements.

Service Business		Merchandising Business	
Fees earned	$ XXX	Sales	$ XXX
Operating expenses	(XXX)	Cost of merchandise sold	(XXX)
Operating income	$ XXX	Gross profit	$ XXX
		Operating expenses	(XXX)
		Operating income	$ XXX

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Financial Statements

- The revenue activities of a service business involve providing services to customers.
- On the income statement for a service business, the revenues from services are reported as fees earned.
- The operating expenses incurred in providing the services are subtracted from the fees earned to arrive at net income.

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Financial Statements
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- In contrast, the revenue activities of a merchandising business involve the buying and selling of merchandise.
- A merchandising business first purchases merchandise to sell to its customers.
- When this merchandise is sold, the revenue is reported as **sales**, and its cost is recognized as an expense called **cost of merchandise sold**.
  - The cost of merchandise sold is subtracted from sales to arrive at **gross profit**, which is the profit before deducting operating expenses.

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Financial Statements
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- Merchandise on hand (not sold) at the end of an accounting period is called **merchandise inventory**.
- It is reported as a current asset on the balance sheet.

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Chart of Accounts for a Merchandising Business

- Merchandise transactions are recorded in the accounts using the rules of debits and credits.
- Most merchandising companies use accounting systems with computerized reports that are similar to special journals and subsidiary ledgers.
  - A merchandising account system typically produces sales and inventory reports.

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Purchases Transactions
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- There are two systems for accounting for merchandise transactions: perpetual and periodic.
  - In a **perpetual inventory system**, each purchase and sale of merchandise is recorded in the inventory account and related subsidiary ledger.
    - In this way, the amount of merchandise available for sale and the amount sold are continuously (perpetually) updated in the inventory records.
  - In a **periodic inventory system**, the inventory does not show the amount of merchandise available for sale and the amount sold.
    - Instead, a listing of inventory on hand, called a physical inventory, is prepared at the end of the accounting period.
      - This physical inventory is used to determine the cost of merchandise on hand at the end of the period and the cost of merchandise sold during the period.

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Purchases Transactions
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- The terms of purchases on account are normally indicated on the **invoice** or bill that the seller sends the buyer.
- The terms for when payments for merchandise are to be made are called the **credit terms**.
  - If payment is required on delivery, the terms are cash or net cash.
  - Otherwise, the buyer is allowed an amount of time, known as the **credit period**, in which to pay.
    - The credit period usually begins with the date of the sale as shown on the invoice.

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Purchases Discounts
(slide 1 of 2)

- To encourage the buyer to pay before the end of the credit period, the seller may offer a discount.
  - For example, a seller may offer a 2% discount if the buyer pays within 10 days of the invoice date. If the buyer does not take the discount, the total invoice amount is due within 30 days.
    - The terms are expressed as 2/10, n/30 and are read as "2% discount if paid within 10 days, net amount due within 30 days."

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Purchases Discounts
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- Discounts taken by the buyer for early payment of an invoice are called **purchases discounts**.
  - Purchases discounts taken by a buyer reduce the cost of the merchandise purchased.
- Since buyers normally take all purchases discounts, Merchandise Inventory is debited for the net purchase price under the perpetual inventory system.
  - That is, the buyer debits Merchandise Inventory for the amount of the invoice less the discount.

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Purchases Returns and Allowances
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- A buyer may request an allowance for merchandise that is returned (purchases return) or a price allowance (purchases allowance) for damaged or defective merchandise. From a buyer's perspective, such returns and allowances are called **purchases returns and allowances**.
  - In both cases, the buyer normally sends the seller a **debit memorandum**, often called a **debit memo**, to notify the seller of reasons for the return (purchase return) or to request a price reduction (purchase allowance).
    - A debit memo also informs the seller of the amount the buyer proposes to debit to the account payable due the seller.

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Purchases Returns and Allowances
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- The buyer may use the debit memo as the basis for recording the return or allowance or wait for approval from the seller (creditor).
- In either case, the buyer debits Accounts Payable and credits Merchandise Inventory.
- Before paying an invoice, a buyer may return merchandise or be granted a price allowance for an invoice with a purchase discount.
  - In this case, the amount of the return is recorded at its invoice amount less the discount.

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Sales Transactions

- Revenue from merchandise sales is usually recorded as Sales.
  - Sometimes a business may use the title Sales of Merchandise.

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Cash Sales
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- Using the perpetual inventory system, the cost of merchandise sold and the decrease in merchandise inventory are also recorded.
  - In this way, the merchandise inventory account indicates the amount of merchandise on hand (not sold).

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Cash Sales
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- Sales may be made to customers using credit cards such as MasterCard or VISA.
  - Such sales are recorded as cash sales.
    - This is because these sales are normally processed by a clearinghouse that contacts the bank that issued the card.
      - The issuing bank then electronically transfers cash directly to the retailer's bank account. Thus, the retailer normally receives cash within a few days of making the credit card sale.
- Any processing fees charged by the clearinghouse or issuing bank are periodically recorded as an expense.
  - This expense is normally reported on the income statement as an administrative expense.

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Customer Discounts

- A seller may grant customers a variety of discounts, called **customer discounts**, to encourage customers to act in a way benefiting the seller.
  - For example, a seller may offer customer discounts to encourage customers to purchase in volume or order early.
- A **sales discount** encourages customers to pay their invoice early.
  - For example, a seller may offer credit terms of 2/10, n/30, which provides a 2% sales discount if the invoice is paid within 10 days.

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Customer Refunds and Allowances
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- A buyer may receive merchandise that is defective, has been damaged during shipment, or does not meet the buyer's expectations.
- In these cases, the seller may pay the buyer a **cash refund** or grant a **customer allowance** that reduces the account receivable owed on the original selling price.
- If the buyer is paid a refund, the seller debits Customer Refunds Payable and credits Cash.

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Customer Refunds and Allowances

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- **Customer refunds payable** is a liability account for estimated refunds and allowances that will be paid or granted customers in the future.
  - It is recorded at the end of the accounting period as part of the adjusting process.
- In some cases, a customer who is due a refund has an outstanding account receivable balance. Instead of paying a cash refund, the seller may grant the customer an allowance against the customer's account receivable.
  - When this is done, the seller sends the buyer a **credit memorandum**, or **credit memo**, indicating its intent to credit the customer's account receivable.

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Customer Returns
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- When customers return merchandise for a cash refund or allowance, an additional entry must be made.
- This additional entry debits Merchandise Inventory and credits Estimated Returns Inventory for the seller's original cost of the returned merchandise.

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Customer Returns
(slide 2 of 2)

- **Estimated returns inventory** is a current asset that is reported on the balance sheet after Merchandise Inventory.
  - It represents an estimate of merchandise that will be returned by customers.
- It is recorded at the end of the accounting period as part of the adjusting process.

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Freight
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- Purchases and sales of merchandise often involve freight.
- The terms of a sale indicate when ownership (title and control) of the merchandise passes from the seller to the buyer.
  - This point determines whether the buyer or the seller pays the freight costs.

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Freight
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- The ownership of the merchandise may pass to the buyer when the seller delivers the merchandise to the freight carrier.
  - In this case, the terms are said to be **FOB (free on board) shipping point**.
    - This term means that the buyer pays the freight costs from the shipping point to the final destination.
      - Such costs are part of the buyer's total cost of purchasing inventory and are added to the cost of the inventory by debiting Merchandise Inventory.

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Freight
(slide 3 of 4)

- The ownership of the merchandise may pass to the buyer when the buyer receives the merchandise.
  - In this case, the terms are said to be **FOB (free on board) destination**.
    - This term means that the seller pays the freight costs from the shipping point to the buyer's final destination.
      - When the seller pays the delivery charges, the seller debits Delivery Expense or Freight Out.
        - Delivery Expense is reported on the seller's income statement as a selling expense.

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Freight
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- The seller may prepay the freight, even though the terms are FOB shipping point. The seller will then add the freight to the invoice.
  - The buyer debits Merchandise Inventory for the total amount of the invoice, including the freight.
  - Any discount terms would not apply to the prepaid freight.

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Dual Nature of Merchandise Transactions

- Each merchandising transaction affects a buyer and a seller.

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Sales Taxes

- Almost all states levy a tax on sales of merchandise.
- The liability for the sales tax is incurred when the sale is made.
  - At the time of a cash sale, the seller collects the sales tax.
  - When a sale is made on account, the seller charges the tax to the buyer by debiting Accounts Receivable.
  - The seller credits the sales account for the amount of the sale and credits the tax to Sales Tax Payable.

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Trade Discounts
(slide 1 of 2)

- Wholesalers are companies that sell merchandise to other businesses rather than to the public.
  - Many publish sales catalogs or upload sales catalogs online.
- In addition, wholesalers often offer special discounts to government agencies or businesses that order large quantities.
  - Such discounts are called **trade discounts**.

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Trade Discounts
(slide 2 of 2)

- Sellers and buyers do not normally record the list prices of merchandise and trade discounts in their accounts.
  - For example, assume that an item has a list price of $1,000 and a 40% trade discount. The seller and buyer records the sale of the item at $600 [$1,000 less the trade discount of $400 ($1,000 × 40%)]. Likewise, the buyer records the purchase the purchase at $600.

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Adjusting Entry for Inventory Shrinkage
(slide 1 of 2)

- Under the perpetual inventory system, the merchandise inventory account is continually updated for purchase and sales transactions.
- As a result, the balance of the merchandise inventory account is the amount of merchandise available for sale at that point in time.
- However, retailers normally experience some loss of inventory due to shoplifting, employee theft, or errors.
- Thus, the physical inventory on hand at the end of the accounting period is usually less than the balance of Merchandise Inventory.
  - This difference is called **inventory shrinkage** or **inventory shortage**.

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Adjusting Entry for Inventory Shrinkage
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- After the entry is recorded, the balance of Merchandise Inventory agrees with the physical inventory on hand at the end of the period.
- Since inventory shrinkage cannot be totally eliminated, it is considered a normal cost of operations.
  - If the amount of the shrinkage is unusually large, it may be disclosed separately on the income statement. In such cases, the shrinkage may be recorded in a separate account, such as Loss from Inventory Shrinkage.

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Adjusting Entry for Customer Refunds, Allowances, and Returns (slide 1 of 2)

- Sellers are required to estimate returns and allowances at the end of an accounting period and prepare two adjusting entries:
  1. The first adjusting entry reduces the sales account and creates a customer refund liability account for the estimated refunds and allowances that will be granted to customers in the future.
  2. The second adjusting entry creates an estimated returns inventory account for the cost of merchandise that is expected to be returned and reduces cost of merchandise sold.

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Adjusting Entry for Customer Refunds, Allowances, and Returns (slide 2 of 2)

- Estimated Returns Inventory is debited rather than Merchandise Inventory because the type of merchandise returned will not be known until the returns actually occur.
- The adjusting entries ensure that the current period sales are matched with the related cost of merchandise sold on the income statement.

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Financial Statements for a Merchandising Business

- Although merchandising transactions affect the balance sheet in reporting inventory, they primarily affect the income statement.
- An income statement for a merchandising business is normally prepared using either a multiple-step or single-step format.

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Multiple-Step Income Statement

- The **multiple-step income statement** contains several sections, subsections, and subtotals, including the following:
  - Sales
  - Cost of Merchandise Sold
  - Gross Profit
  - Income from Operations
  - Other Income and Expense

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Multiple-Step Income Statement—Sales

- The total amount of sales to customers for cash and on account is reported in this section.

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Multiple-Step Income Statement—Cost of Merchandise Sold

- The amount of cost of merchandise sold to customers is reported in this section.
- Cost of merchandise sold may also be reported as cost of goods sold or cost of sales.

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Multiple-Step Income Statement—Gross Profit

- The excess of sales over cost of merchandise sold is gross profit.

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Multiple-Step Income Statement—Income from Operations

- **Income from operations**, or operating income, is determined by subtracting operating expenses from gross profit.
  - Operating expenses are normally classified as either selling expenses or administrative expenses.
    - **Selling expenses** are incurred directly in the selling of merchandise.
      - Examples of selling expenses include the following:
        - Sales salaries
        - Store supplies used
        - Depreciation of store equipment
        - Delivery expense
        - Advertising
    - **Administrative expenses**, sometimes called **general expenses**, are incurred in the administration or general operations of the business.
      - Examples of administrative expenses include the following:
        - Office salaries
        - Depreciation of office equipment
        - Office supplies used

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Multiple-Step Income Statement—Other Income and Expense (slide 1 of 2)

- Other income and expense items are not related to the primary operations of the business.
  - Other income is revenue from sources other than the primary operating activity of a business.
    - Examples of other income include the following:
      - Income from interest
      - Rent
      - Gains resulting from the sale of fixed assets
  - Other expense is an expense that cannot be traced directly to the normal operations of the business.
    - Examples of other expenses include the following:
      - Interest expense
      - Losses from disposing of fixed assets

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Multiple-Step Income Statement—Other Income and Expense (slide 2 of 2)

- Other income and other expense are offset against each other on the income statement.
  - If the total of other income exceeds the total of other expense, the difference is added to income from operations to determine net income.
  - If the total of other expense exceeds the total of other income, the difference is subtracted from income from operations to determine net income.

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Single-Step Income Statement

- An alternative form of income statement is the **single-step income statement**.
- The single-step form deducts the total of all expenses in one step from the total of all revenues.
- The single-step form emphasizes total revenues and total expenses in determining net income.
- A criticism of the single-step form is that gross profit and income from operations are not reported.

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The Closing Process
(slide 1 of 2)

- The closing entries for a merchandising business are similar to those for a service business. The two closing entries for a merchandising business are as follows:
  1. Debit each revenue account for its balance, credit each expense account for its balance, and credit owner's capital account for net income. Debit the owner's capital account for a net loss. Cost of merchandise sold is a temporary account and is closed like an expense account.
  2. Debit the owner's capital account for the balance of the drawing account and credit the drawing account.

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The Closing Process

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- After the closing entries are posted to the accounts, a post-closing trial balance is prepared.
  - The only accounts that should appear on the post-closing trial balance are the asset, contra asset, liability, and owner’s capital accounts with balances.
    - These are the same accounts that appear on the end-of-period balance sheet.
  - If the two totals of the trial balance columns are not equal, an error has occurred that must be found and corrected.

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Financial Analysis and Interpretation: Asset Turnover

- **Asset turnover**, sometimes called the ratio of sales to assets, measures how effectively a business is using its assets to generate sales.
- A high ratio indicates an effective use of sales.
- The asset turnover is computed as follows:

$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Average Total Assets}}$$

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Appendix: Periodic Inventory System
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- Small merchandise businesses, such as a local hardware store, may use a manual accounting system.
- A manual perpetual inventory system is time consuming and costly to maintain.
- In this case, the periodic inventory system may be used.

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Appendix: Periodic Inventory System
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- Under the periodic inventory system, purchases are normally recorded at their invoice amount.
  - If the invoice is paid within the discount period, the discount is recorded in a separate account called Purchases Discounts.
  - Likewise, purchase returns are recorded in a separate account called Purchase Returns and Allowances.

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Appendix: Recording Merchandise Transactions Under the Periodic Inventory System (slide 1 of 2)

- Using the periodic inventory system, purchases of inventory are not recorded in the merchandise inventory account.
  - Instead, purchases, purchases discounts, and purchases returns and allowances accounts are used.
- In addition, the sales of merchandise are not recorded in the inventory account.
- Thus, there is no detailed record of the amount of inventory on hand at any given time.
- At the end of the period, a physical count of merchandise inventory on hand is taken.
  - This physical count is used to determine the cost of merchandise sold.

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Appendix: Recording Merchandise Transactions Under the Periodic Inventory System—Purchases

- Purchases of inventory are recorded in a purchases account rather than in the merchandise inventory account.
- Purchases is debited for the invoice amount of a purchase.

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Appendix: Recording Merchandise Transactions Under the Periodic Inventory System—Purchases Discounts

- Purchases discounts are normally recorded in a separate purchases discounts account.
- The balance of the purchases discounts account is reported as a deduction from Purchases for the period.
- Thus, Purchases Discounts is a contra (or offsetting) account to Purchases.

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Appendix: Recording Merchandise Transactions Under the Periodic Inventory System—Purchases Returns and Allowances

- A separate purchases returns and allowances account is used to record returns and allowances.
- Purchases returns and allowances are reported as a deduction from Purchases for the period.
- Thus, Purchases Returns and Allowances is a contra (or offsetting) account to Purchases.

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Appendix: Recording Merchandise Transactions Under the Periodic Inventory System—Freight In

- Under the periodic inventory system, freight paid when purchasing merchandise FOB shipping point is debited to Freight In, Transportation In, or a similar account.

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Appendix: Recording Merchandise Transactions Under the Periodic Inventory System (slide 2 of 2)

Account	Entry to Increase	Normal Balance	Effect on Cost of Merchandise Purchased
Purchases	Debit	Debit	Increases
Purchases Discounts	Credit	Credit	Decreases
Purchases Returns and Allowances	Credit	Credit	Decreases
Freight In	Debit	Debit	Increases

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Appendix: Adjusting Process Under the Periodic Inventory System (slide 1 of 2)

- The adjusting process is the same under the periodic and perpetual inventory systems except for the inventory shrinkage adjustment and customer refunds and allowances.
- Under the perpetual inventory system, the ending inventory physical count is compared to the balance of Merchandise Inventory.
  - The difference is the amount of inventory shrinkage.
  - The inventory shrinkage is then recorded as a debit to Cost of Merchandise Sold and a credit to Merchandise Inventory.
- Under the periodic inventory system, the merchandise inventory account is not kept up to date for purchases and sales.
  - As a result, the inventory shrinkage cannot be directly determined.
  - Instead, any inventory shrinkage is included indirectly in the computation of the cost of merchandise sold.
  - Inventory shrinkage not being separately determined is a major disadvantage of the periodic inventory system.

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Appendix: Adjusting Process Under the Periodic Inventory System (slide 2 of 2)

- Like the perpetual inventory system, the periodic system records the same adjusting entry debiting Sales and crediting Customer Refunds Payable for estimated customer refunds and allowances.
- No entry, however, is made for estimated returns inventory. Instead, cost of merchandise sold is reduced by the cost of the estimated returns inventory for the current year.

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Appendix: Closing Entries Under the Periodic Inventory System (slide 1 of 2)

- The closing entries differ in the periodic inventory system in that there is no cost of merchandise sold account to close to Income Summary.
- Instead, the purchases, purchases discounts, purchases returns and allowances, and freight in accounts are closed to Income Summary.
- In addition, the merchandise inventory account is adjusted to the end-of-period physical inventory count during the closing process.

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Appendix: Closing Entries Under the Periodic Inventory System (slide 2 of 2)

- The two closing entries under the periodic inventory system are as follows:
  1.
     a. Debit Merchandise Inventory for its end-of-period balance based on the physical inventory.
     b. Debit Estimated Returns Inventory for the cost of the future estimated returns of the current period's sales.
     c. Debit each revenue account and the following temporary periodic inventory accounts for their balances.
        - Purchases Discounts
        - Purchases Returns and Allowances
     d. Credit Merchandise Inventory for its balance as of the beginning of the period.
     e. Credit each expense account and the following temporary periodic inventory accounts for their balances.
        - Purchases
        - Freight In
     f. Credit the owner's capital account (Chris Clark, Capital) for the net income. Debit the owner's capital account for a net loss.
  2. Debit the owner's capital account (Chris Clark, Capital) and credit the owner's drawing account (Chris Clark, Drawing) for its balance.

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