MERCHANDISING OPERATIONS AND THE MULTI-STEP INCOME STATEMENT

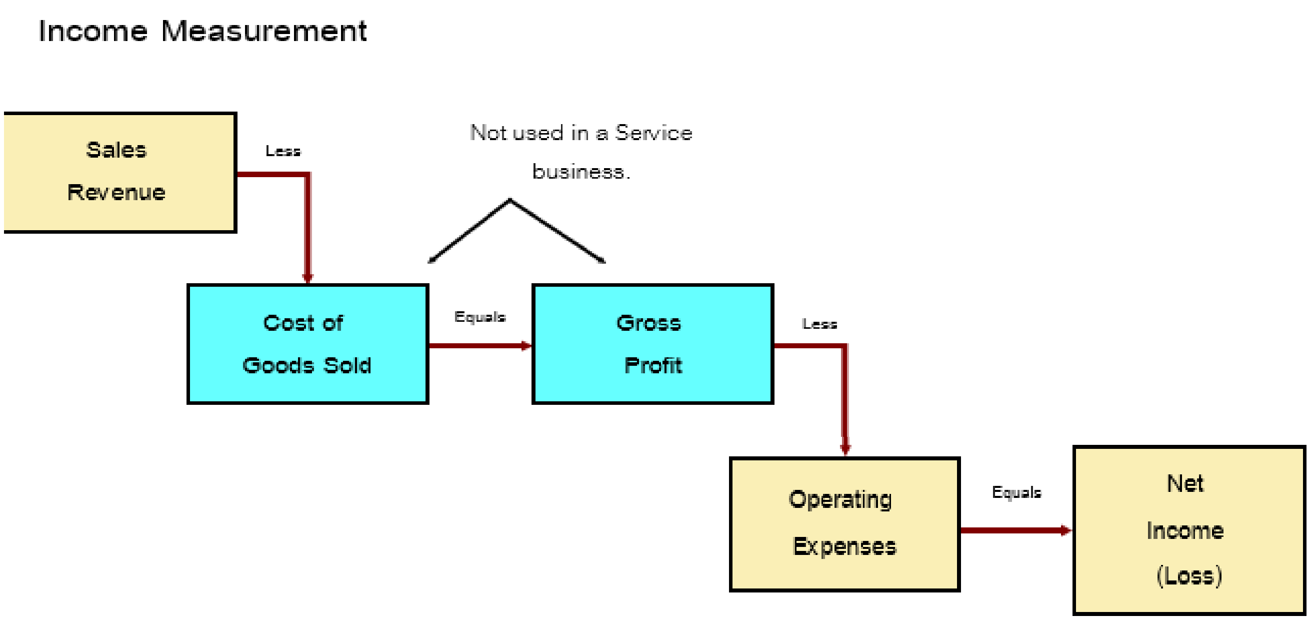
LO 1: Describe merchandising operations and inventory systems.

- Primary source of revenue for merchandisers like Walmart that buy and sell goods is referred to as **sales revenue.**
- **Cost of goods sold** is the total cost of merchandise sold during the period.
  - It is an **EXPENSE** that is directly related to the revenue recognized from the sale of goods.

Ex: Company C, a retailer, bought chairs from a wholesaler for $15 each. Company C then sold the chairs to their customers for $20 each.

- The $20 represents Company C's sales revenue for each chair.
- The $15 that Company C spent on each chair represents Company C's cost of goods sold and is recognized when each chair is sold to customers.

***Key Formula: Sales Revenue – Cost of Goods Sold = **Gross Profit**



FLOW OF COSTS

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

1. <u>Perpetual</u>: CONTINUOUSLY updates accounting records for merchandising transactions – SPECIFICALLY **reduction of inventory** and **increasing cost of goods sold**.

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

2. <u>Periodic</u>: updates the accounting records for merchandise transactions at the **END OF A PERIOD**.

- Cost of goods sold determined by count at the end of the accounting period.

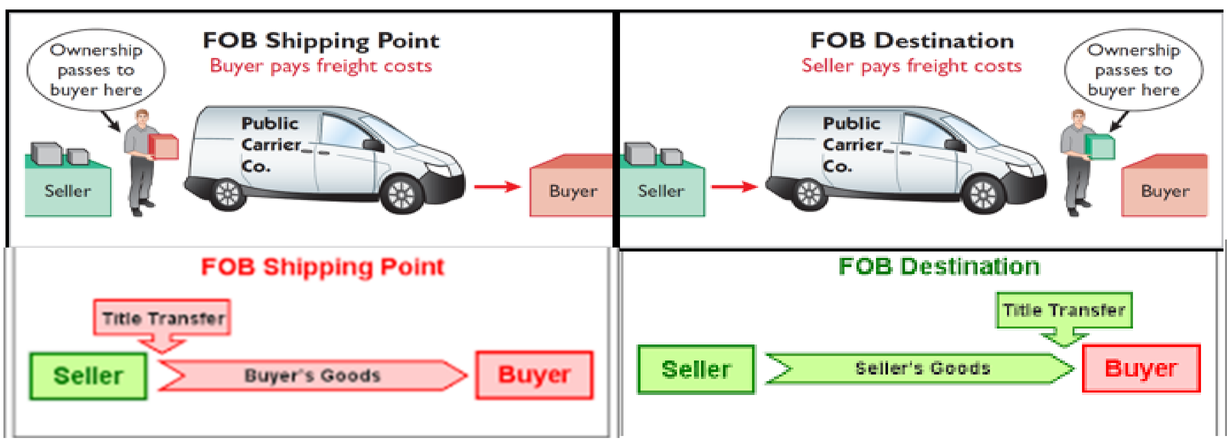
***Key Formula… **Cost of Goods Sold** = Beginning Inventory + Net Purchases – Ending Inventory

Beginning Inventory	$	200,000
Add: Purchases, net	$	900,000
Goods available for sale	$	1,100,000
Less: Ending Inventory	$	400,000
Cost of Goods Sold	**$**	**700,000**

LO 2: Record purchases under a perpetual inventory system.

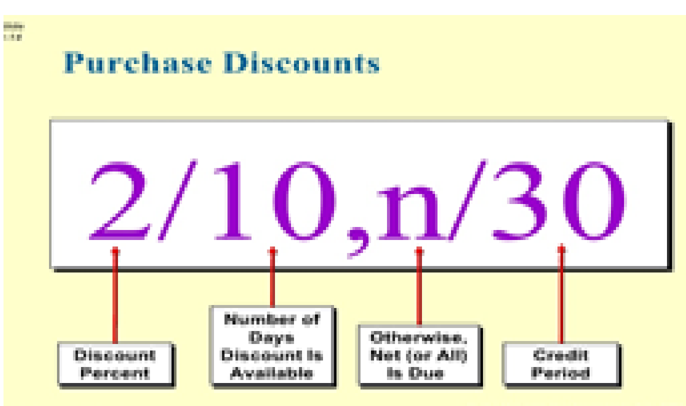
FREIGHT COSTS

Shipping Terms	Ownership Transfers when goods passed to	Freight cost paid by
1. **FOB (Free on Board) Shipping Point**: GOODS ARE BUYERS AS SOON AS CARRIER GETS THEM.	1. **CARRIER**	1. **BUYER** **Inventory** **xxx** **Cash** **xxx**
2. **FOB (Free on Board) Destination**: GOODS ARE SELLERS UNTIL THEY REACH BUYER.	2. **BUYER**	2. **SELLER** **Freight-Out** **xxx** **Cash** **xxx**



PURCHASE DISCOUNTS

- Buyer receives a cash discount for prompt payment.
  - Saves the buyer money and helps the seller collect money faster.



What does this mean?

*The buyer can **deduct 2% of the invoice amount** if **payment is made within 10 days** of the invoice date, otherwise **full payment is due within a 30-day** credit period.

*Simply…The buyer gets a 2% discount if they pay within 10 days, otherwise the full amount is due in 30 days.

PURCHASE DISCOUNTS (Cont.)

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

PURCHASE RETURNS AND ALLOWANCES

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

Summary of Purchasing Journal Entries- Perpetual

			DEBIT	CREDIT
BUYER	1. Purchase inventory ON ACCOUNT.	Inventory	xxx	
		Accounts Payable		xxx
	2. Purchase inventory for CASH.	Inventory	xxx	
		Cash		xxx
	3. Paying freight costs on purchases (FOB Shipping Point)	Inventory	xxx	
		Cash		xxx
	4. Paying <u>WITHIN</u> discount period.	Accounts Payable	xxx	
		Inventory (For purchase discount)		xxx
		Cash		xxx
	5. Paying <u>OUTSIDE</u> discount period.	Accounts Payable	xxx	
		Cash		xxx
	6. Recording Purchase Returns and Allowances.	Cash or Accounts Payable	xxx	
		Inventory		xxx

Example Journal Entries

Jay Company bought inventory from Z Company on January 1 for $10,000 under the credit terms 3/15, n/60. On January 10, Jay Company returned goods costing $1,000 to Z Company. Jay Company paid Z Company for the remaining goods on Jan. 12.

What are the journal entries that need to be recorded in January for Jay Company?

	Date	**Debit**	**Credit**
Inventory	**Jan. 1**	10,000	
Accounts Payable- Z Company			10,000
Accounts Payable- Z Company	**Jan. 10**	1,000	
Inventory			1,000
Accounts Payable- Z Company **(10,000 – 1,000)**	**Jan. 12**	9,000	
Inventory **(9,000 × 3% = $270)**			270
Cash			8,730

LO 3: Record sales under a perpetual inventory system.

S E L L E R

Transaction	Account	Debit	Credit
1. Selling Merchandise ON ACCOUNT (**2 Journal Entries**- Record **sale** and to show a decrease in **inventory sold.**)	Accounts Receivable	xxx	
	Sales Revenue		xxx
	Cost of Goods	xxx	
	Inventory		xxx
2. Selling Merchandise for CASH (**2 Journal Entries**- Record **sale** and to show a decrease in **inventory sold.**)	Cash	xxx	
	Sales Revenue		xxx
	Cost of Goods	xxx	
	Inventory		xxx
3. Receiving payment **WITHIN** the discount period.	Cash	xxx	
	Sales Discounts	xxx	
	Accounts Receivable		xxx
4. Receiving payment **OUTSIDE** the discount period.	Cash	xxx	
	Accounts Receivable		xxx
5. Granting Sales Returns or Allowances (**2 Journal Entries)**	Sales Returns and Allowances	xxx	
	Cash or Accounts Receivable		xxx
	Inventory	xxx	
	Cost of Goods		xxx
6. Paying freight costs on sales; FOB Destination.	Freight-Out	xxx	
	Cash		xxx

SALES RETURNS AND ALLOWANCES

- Used when the seller either accepts goods back from a purchaser (a return) or grants a reduction in the purchase price (an allowance) so that the buyer will keep the goods.
- **Contra-revenue account** on the income statement and has a **Debit** balance.

SALES DISCOUNTS

- Issued by the seller to obtain their money from the customer faster.
- **Contra-revenue account** on the income statement and has a **Debit** balance.

Sales Revenue – Sales Returns and Allowances – Sales Discounts = **Net Sales**

Net Sales – Cost of Goods Sold = **Gross Profit**

Example Journal Entries

- Jay Company sold goods costing $6,000 to X Company for $10,000 on March 1 under the terms 2/10, net 30. On March 5, X Company returned goods to Jay Company with a selling price of $3,000 and a cost of $1,800. On March 10, Jay Company received payment from X Company for the remainder of the goods.

What are the journal entries that need to be recorded on in March for Jay Company?

	Date	**Debit**	**Credit**
Accounts Receivable- X Company	**Mar. 1**	10,000	
Sales Revenue			10,000
Cost of Goods Sold	**Mar. 1**	6,000	
Inventory			6,000
Sales Returns and Allowances	**Mar. 5**	3,000	
Accounts Receivable- X Company			3,000
Inventory	**Mar. 5**	1,800	
Cost of Goods Sold			1,800
Cash	**Mar. 10**	6,860	
Sales Discounts **(7,000 × 2% = $140)**		140	
Accounts Receivable- X Company **(10,000 -3,000)**			7,000

LO 5: Apply the steps in the accounting cycle to a merchandising company.

Each of the required steps described in Chapter 4 for service companies applies to merchandising companies.

Adjusting Entries

A merchandising company generally has the same types of adjusting entries as a service company. However, a merchandiser using a perpetual system will require one additional adjustment to make the records agree with the actual inventory on hand. Here’s why: At the end of each period, for control purposes, a merchandising company that uses a perpetual system will take a physical count of its goods on hand.

The company’s unadjusted balance in Inventory usually does not agree with the actual amount of inventory on hand. The perpetual inventory records may be incorrect due to recording errors, theft, or waste. Thus, the company needs to adjust the perpetual records to make the recorded inventory amount agree with the inventory on hand.

- **This adjustment impacts Inventory and Cost of Goods Sold.**

For example, suppose that PW Audio Supply, Inc. has an **unadjusted** balance of $40,500 in Inventory.

Through a physical count, PW Audio Supply determines that its **actual** merchandise inventory at December 31 is $40,000. The company would make an adjusting entry as follows.

Dec. 31	Cost of Goods Sold	500	
	Inventory ($40,500 – $40,000)		500
	(To adjust inventory to physical count)		

Closing Entries

A merchandising company, like a service company, closes to Income Summary all accounts that affect net income. In journalizing, the company credits all temporary accounts with debit balances, and debits all temporary accounts with credit balances. It also closes both Income Summary and Dividends to Retained Earnings. (Hint – R.E.D – temporary accounts are Revenue, Expense, and Dividends)

The following are the closing entries for PW Audio Supply using assumed amounts from its year-end adjusted trial balance.

- **Cost of Goods Sold** is an expense account with a normal debit balance,
- **Sales Returns and Allowances and Sales Discounts** are contra revenue accounts with normal debit balances

The easiest way to prepare the first two closing entries is to identify the temporary accounts by their balances and then prepare one entry for the credits and one for the debits.

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)		
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)		

After PW Audio Supply has posted the closing entries, all temporary accounts have zero balances. Also, Retained Earnings has a balance that is carried over to the next period

LO 5: Prepare a multi-step income statement

SINGLE-STEP INCOME STATEMENT

- Subtract total expenses from total revenues
- Two reasons for using the single-step format:
    1. Company does not realize any type of profit or income until total revenues exceed total expenses.
    2. Form is simple and easy to read.

Real World

RECREATIONAL EQUIPMENT, INC.
Income Statements
(in thousands)

	For the year ended	
	January 3, 2015	December 28, 2013
Revenues		
Net sales	$2,217,131	$2,017,476
Expenses		
Cost of goods sold	1,257,002	1,148,668
Payroll-related expenses	423,061	393,505
Occupancy, general and administrative	355,190	345,643
Patronage refunds and other	110,611	100,802
Income taxes	27,149	10,017
	2,173,013	1,998,635
Net income	$ 44,118	$ 18,841

MULTI-STEP INCOME STATEMENT

- Highlights the components of net income.
- Three important line items:
  1. **Gross profit**
  2. **Income from Operations**
  3. **Net Income**

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.

Real World

RECREATIONAL EQUIPMENT, INC.
Income Statements
(in thousands)

	For the year ended	
	January 3, 2015	**December 28, 2013**
Net sales	$2,217,131	$2,017,476
Cost of goods sold	1,257,002	1,148,668
Gross profit	960,129	868,808
Operating expenses		
Payroll-related expenses	423,061	393,505
Occupancy, general and administrative	355,190	345,643
Total operating expenses	778,251	739,148
Income from operations	181,878	129,660
Other revenues and gains		
Other revenues	-0-	-0-
Other expenses and losses		
Patronage refunds and other	110,611	100,802
Income before income taxes	71,267	28,858
Income tax expense	27,149	10,017
Net income	$ 44,118	$ 18,841

*****ALL OF THESE ITEMS ARE PART OF <u>NONOPERATING ACTIVITIES</u> AND ARE ADDED OR DEDUCTED FROM INCOME FROM OPERATIONS TO GET INCOME BEFORE TAXES.**