MERCHANDISING OPERATIONS AND THE MULTI-STEP INCOME STATEMENT

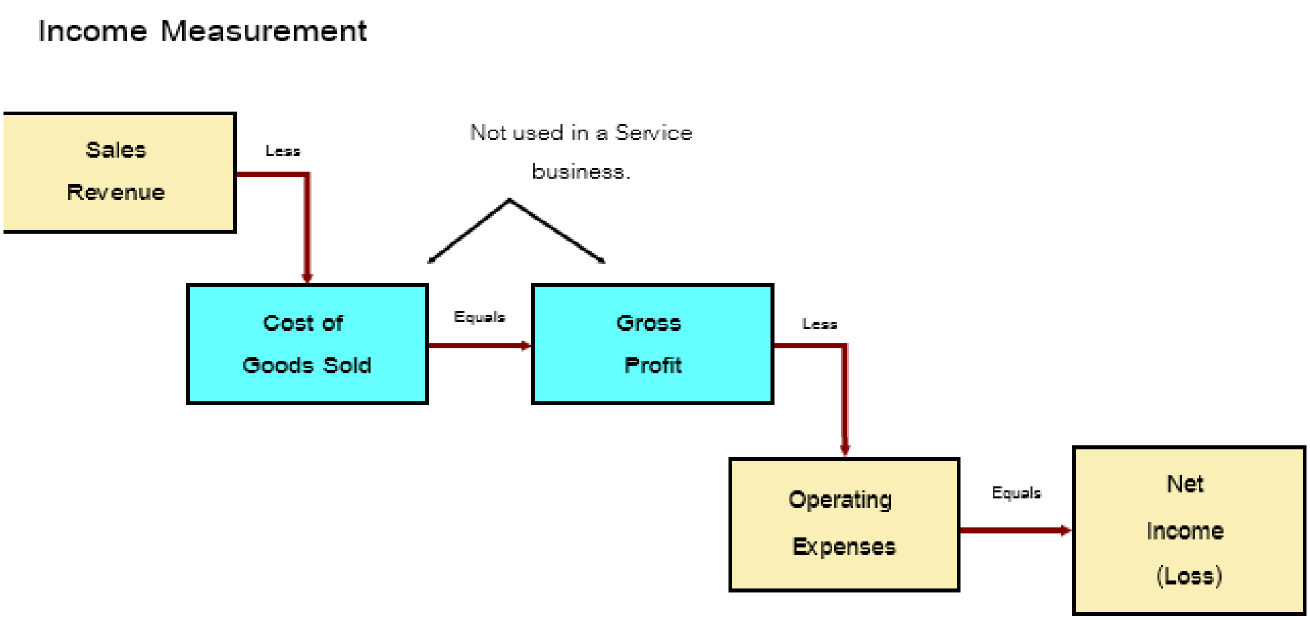
LO 1: Describe merchandising operations and inventory systems.

- 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. Perpetual: 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. Periodic: 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.

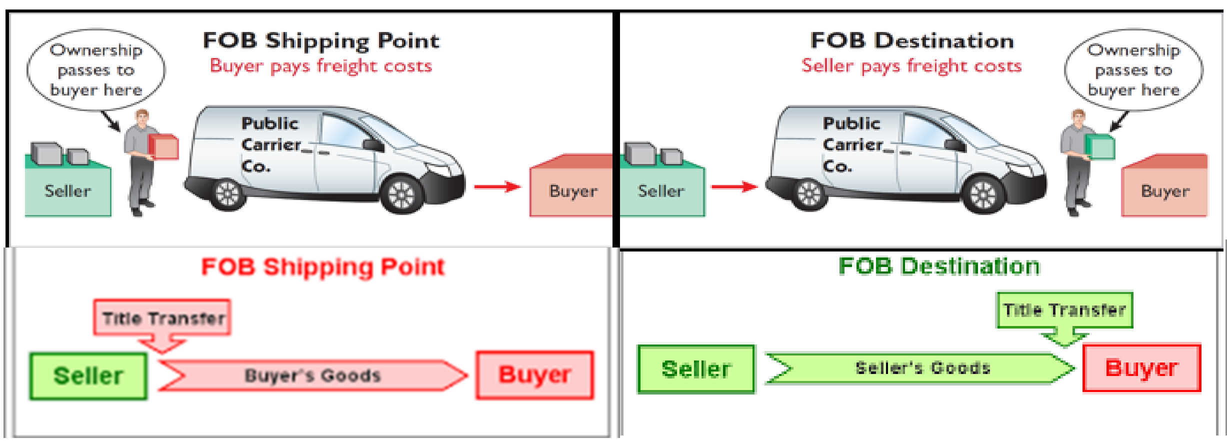
***Key Formula… **Cost of Goods Sold** = Beginning Inventory + Net Purchases – Ending Inventory

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.

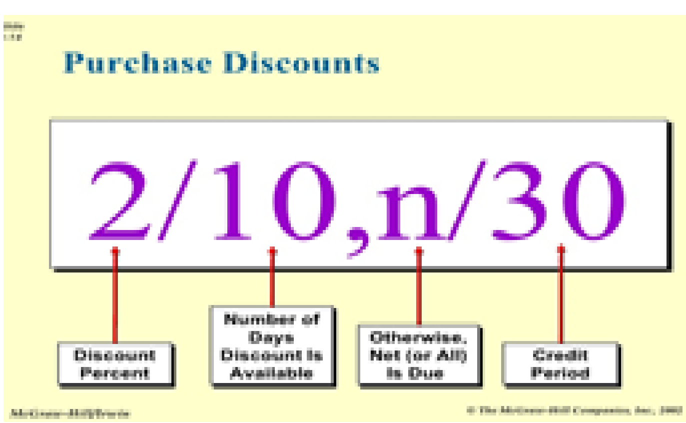
FREIGHT COSTS

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

	Transaction	Account	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 WITHIN discount period.	Accounts Payable	xxx	
		Inventory (For purchase discount)		xxx
		Cash		xxx
	5. Paying OUTSIDE 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.

SELLER

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 **<u>WITHIN</u>** the discount period.	Cash	xxx	
	Sales Discounts	xxx	
	Accounts Receivable		xxx
4. Receiving payment **<u>OUTSIDE</u>** 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 4: Prepare a multi-step income statement and a comprehensive 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.**

COMPREHENSIVE INCOME

- A more inclusive earnings measure that includes items not part of net income including
  - Certain adjustments to pension plan assets.
  - Gains and losses on foreign currency translation.
  - Unrealized gains and losses on certain types of investments.
- Financial Statement is known as a **comprehensive income statement**.
- Either reported in a combined statement of net income and comprehensive income, or in a separate comprehensive income statement.

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

Net income	$21,500
Other comprehensive income	
Unrealized holding gain on investment securities (net of $400 tax)	2,300
Comprehensive income	$23,800

LO 5: Determine cost of goods sold under a periodic inventory 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.

Cost of Goods Sold = Beginning Inventory + Net Purchases + Freight-In – Ending Inventory

***__Net Purchases__ = Purchases – Purchase Returns and Allowances – Purchase Discounts

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
Inventory, December 31			**40,000**
Cost of goods sold			**$316,000**

LO 6: Compute and analyze gross profit rate and profit margin.

GROSS PROFIT RATE

$$\text{Gross Profit Rate} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

- **Gross Profit** = Net Sales Revenue – Cost of Goods Sold
- Measures the margin by which selling price exceeds cost of goods sold.
- Gross Profit Rate of 20% means that for every $1 of sales, a company keeps $0.20 after paying for their inventory **(cost of goods sold)**

PROFIT MARGIN RATIO

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

- Measures the extent by which selling price covers all expenses (including cost of goods sold).
- Profit Margin Ratio of 20% means that for every $1 of sales, a company keeps $0.20 after paying for ALL expenses.

QUALITY OF EARNINGS RATIO

$$\text{Quality of Earnings Ratio} = \frac{\text{Net Cash Provided by Operating Activities}}{\text{Net Income}}$$

- A measure significantly less than 1 suggests that a company may be using more aggressive accounting techniques in order to accelerate income recognition.
- A measure significantly greater than 1 suggests that a company is using conservative accounting techniques which cause it to delay the recognition of income.