

ACCOUNTING FOR MERCHANDISING OPERATIONS

Key Terms and Concepts to Know

Merchandising or Retail Business vs. Service Business

- Service businesses sell the services of the owners or employees to their customers, such as Verizon
- Merchandising or retail companies sell goods to their customers, such as Wal-Mart

Operating Cycle:

- Purchase merchandise inventory from vendors on account or for cash
- Sell inventory to customers on account
- Collect cash from customers
- Pay cash to vendors
- Repeat again and again
- Note that these steps overlap so that the cash collections from customers may occur before and/or after the cash payments to vendors.

Inventory Method

- Perpetual method or periodic method
- See Basic Inventory Methods Module for review materials

Purchasing Transactions:

- Inventory is always recorded at the final cost to the buyer: purchase price less allowances received from the seller and any cash discounts taken
- If purchase is made FOB shipping point, inventory account is increased for the freight cost necessary to transport the inventory to the buyer's place of business
- If purchase is made FOB destination, seller records the freight cost necessary to transport the inventory to the buyer's place of business as a selling expense
- Inventory account is decreased for the cost of the merchandise returned to the seller less any allowances or discounts already recorded in the ledger.
- Trade discounts are deducted as part of the initial purchase transaction; they are not a purchase discount.

Sales Transactions:

- Revenue is recorded as Sales
- The selling price of the merchandise sold represents revenue to the seller and is one part of the transaction.
- Trade discounts are deducted as part of the initial sale transaction; they are neither a sales discount nor a contra-revenue.
- Inventory account is decreased and Cost of Goods Sold is increased for the cost of the merchandise sold as the second part of the transaction
- The freight cost necessary to transport the inventory to the buyer's place of business is an expense in the period of sale (FOB Destination).
- Transportation Out or Freight Out or Delivery Expense are typical accounts used to record the expense.
- Net sales = Sales – sales discounts – sales returns and allowances

Transportation (Freight) Costs:

- FOB Shipping Point – Purchaser is responsible for paying the shipping charges. They are usually prepaid by the seller and added to the invoice. Buyer adds the shipping costs to inventory. If seller prepays, seller has a receivable from buyer.
- FOB Destination – Seller is responsible for paying the shipping charges and they are recorded as the expense Transportation Out or Freight Out or Delivery Expense. Buyer does not make an entry.
- Transportation freight or delivery costs are not subject to a cash discount.

Credit Terms:

- Generally take the form of 2/10, n/30 where
 - 2 is the discount %
 - 10 is the discount period in days
 - n is the net (total) amount to pay
 - 30 is the number of days after the invoice date that the net amount is due
- Only purchases are subject to the discount; transportation or freight costs paid by the seller on behalf of the buyer are not subject to a discount.
- Cash discounts reduce the cost of inventory for the buyer (credit merchandise inventory)
- Cash discounts reduce revenue for the seller (debit sales discounts, a contra-revenue account)

Reminder:

Always know whether transactions are for the buyer or the seller in the transaction. Some of the accounts used and some of the dollar amounts recorded will differ depending on whether you are the buyer or seller in the transaction.

Key Topics to Know

Note: The same example transactions are presented for Purchase Transactions and Sales Transactions to highlight the differences between cost and selling price.

Purchase Transactions

- When companies purchase goods they intend to sell to customers, the transaction is recorded in the Merchandise Inventory account, a current asset.
- Inventory is recorded at cost, which includes the price paid for the goods plus all necessary costs of getting the inventory to the company's place of business and ready to sell.
- The rules of FOB determine whether freight costs are included in the cost of inventory.

Example #1

\$800 of inventory is purchased for cash, FOB shipping point. In a separate transaction, the purchaser pays \$100 of shipping charges to the shipping company. \$200 of merchandise is subsequently returned.

Required: Prepare journal entries to record these transactions

Solution #1

Merchandise Inventory	800	
Cash		800

Merchandise Inventory	100	
Cash		100

When \$200 of merchandise purchased is returned:

Cash	200	
Merchandise Inventory		200

Example #2

\$800 of inventory is purchased on account, FOB shipping point. The seller pays \$100 to the shipping company on behalf of the buyer, which is added to the seller's invoice. The credit terms offered by the seller are 2/10, n/30. \$200 of merchandise is subsequently returned prior to payment.

Required: Prepare journal entries to record these transactions

Solution #2

Merchandise Inventory	900	
A/P		900

When \$200 of merchandise purchased is returned prior to payment:

A/P	200	
Merchandise Inventory		200

When the invoice is paid within the discount period:

\$800 purchase - \$200 return = \$600 merchandise * 2% = \$12 discount
 \$700 owed (\$600 + \$100 shipping) - \$12 discount = \$688 paid

A/P	700	
Cash		688
Merchandise Inventory		12

Example #3

\$800 of inventory is purchased on account, FOB destination. In a separate transaction, the seller pays \$100 of shipping charges to the shipping company. The credit terms offered by the seller are 2/10, n/30. \$200 of merchandise is subsequently returned prior to payment.

Required: Prepare journal entries to record these transactions

Solution #3

Merchandise Inventory	800	
A/P		800

When \$200 of merchandise purchased is returned prior to payment:

A/P	200	
Merchandise Inventory		200

When the invoice is paid within the discount period assuming credit terms of 2/10, n/30:

\$800 purchase - \$200 return = \$600 merchandise * 2% = \$12 discount

\$600 owed - \$12 discount = \$588 paid

A/P	600	
Cash		588
Merchandise Inventory		12

Sales Transactions

When companies sell merchandise inventory, the transaction requires two journal entries:

- The first entry records the revenue from the sale at the selling price.
- The second entry decreases the inventory account and records the expense of the sale at cost.
- Revenue (sales) is recorded at the time the transaction occurs, regardless of whether payment is received from the buyer. Revenue is always greater the cost of the goods being sold.
- Inventory is decreased for the cost of the inventory sold, which includes the price paid for the goods plus all necessary costs of getting the inventory to the company's place of business and ready to sell as noted above.

The rules of FOB determine whether freight costs are recorded as transportation out, a selling expense.

The seller would record Examples #1, #2 and #3 in Purchase Transactions above as follows. The seller's cost of merchandise was 80% of the selling price.

Example #4

Inventory is sold for \$800 cash, FOB shipping point. In a separate transaction, the purchaser pays \$100 of shipping charges to the shipping company. \$200 of merchandise is subsequently returned.

Required: Prepare journal entries to record these transactions

Solution #4

Cash	800	
Sales		800
Cost of Goods Sold	640	
Merchandise Inventory		640

When \$200 of merchandise is returned:

Sales returns and Allowances	200	
Cash		200
Merchandise Inventory	160	
Cost of Goods Sold		160

Example #5

\$800 of inventory is sold on account, FOB shipping point. The seller pays \$100 to the shipping company on behalf of the buyer, which is added to the seller's invoice. The credit terms offered by the seller are 2/10, n/30. Cost of the merchandise sold is 80% of the selling price. \$200 of merchandise is subsequently returned prior to payment.

Required: Prepare journal entries to record these transactions

Solution #5:

A/R	900	
Sales		800
Accounts Receivable		100
Cost of Goods Sold	640	
Merchandise Inventory		640

When \$200 of merchandise is returned:

Sales Returns and Allowances	200	
Accounts Receivable		200
Merchandise Inventory	160	
Cost of Goods Sold		160

When the invoice is paid within the discount period

\$800 purchase - \$200 return = \$600 merchandise * 2% = \$12 discount

\$700 owed (\$600 + \$100 shipping) - \$12 discount = \$688 paid

Cash	688	
Sales Discounts	12	
Accounts Receivable		700

Example #6:

\$800 of inventory is sold on account, FOB destination. In a separate transaction, the seller pays \$100 to the shipping company. The credit terms offered by the seller are 2/10, n/30. Cost of the merchandise sold is 80% of the selling price. The customer returns \$200 of merchandise purchased prior to payment.

Required: Prepare journal entries to record these transactions

Solution #6:

A/R	800	
Sales		800
Cost of Goods Sold	640	
Merchandise Inventory		640
Transportation Out	100	
Cash		100

When \$200 of merchandise is returned:

Sales Returns and Allowances	200	
A/R		200
Merchandise Inventory	160	
Cost of Goods Sold		160

When the invoice is paid within the discount period

\$800 purchase - \$200 return = \$600 merchandise * 2% = \$12 discount

\$600 owed - \$12 discount = \$588 paid

Cash	588	
Sales Discounts	12	
A/R		600

Practice Problems

Practice Problem #1

J Company engaged in the following transactions during April:

- a) Purchased \$4,000 worth of merchandise on account, terms 2/10, n/30, FOB shipping point. Prepaid transportation charges of \$200 were added to the invoice.
- b) Returned \$500 of merchandise purchased in (a).
- c) Paid on account for purchases in 1 less return 2 and discount.

Required: Prepare journal entries to record these transactions

Practice Problem #2

Following are ten statements regarding purchase and sales transactions:

- a) A buyer issues a _____ to inform the seller of a debit made to the seller's account payable in the buyer's records.
- b) FOB _____ means the buyer is responsible for paying shipping costs and bears the risk of damage or loss when goods are in transit.
- c) Merchandise that customers return to the seller after a sale is referred to as _____.
- d) Reductions in the selling price of merchandise sold to customers, often involving damaged or defective merchandise that a customer is willing to purchase with a decrease in the selling price is referred to as _____.
- e) _____ can benefit a seller by decreasing the delay in receiving cash and reducing future collection efforts.
- f) A seller usually prepares a _____ to confirm a buyer's return or allowance, and informs the buyer of the seller's credit to the buyer's Account Receivable on the seller's books.
- g) FOB _____ means ownership of goods transfers to the buyer when the goods arrive at the buyer's place of business. The seller is responsible for paying shipping charges and bears the risk of damage or loss in transit.
- h) _____ are the amounts and timing of payment from a buyer to a seller.
- i) A period's beginning inventory is equal to the prior period's _____.
- j) A _____ inventory system updates the accounting record for inventory only at the end of an accounting period.

Practice Problem #3

E Company engaged in the following transactions during June:

- a) Purchased merchandise on account from B Company, list price \$15,000, terms FOB shipping point, 2/10, n/30, with prepaid transportation costs of \$650 added to the invoice.
- b) Purchased merchandise on account from C Company, \$8,000, terms FOB destination, 1/10, n/30.
- c) Sold merchandise on account to D Company, \$9,800, terms 2/10, n/30. The cost of the merchandise sold was \$5,800.
- d) Returned \$2,000 of merchandise purchased from Cupid Co. (b)
- e) Paid B Company. on account for purchase in (a) less discount.

Required: Prepare journal entries to record these transactions

Practice Problem #4

K Company engaged in the following transactions during May:

- a) Sold merchandise on account to X Company, \$5,000, terms FOB Shipping Point, 2/10, n/30. The cost of the merchandise sold was \$3,000. Paid transportation charges of \$200, which were added to the invoice.
- b) Sold merchandise on account to Y Company, \$10,000, terms FOB Destination, 1/10, n/30. The cost of the merchandise was \$6,000.
- c) Paid transportation charges of \$400 for delivery of merchandise sold to Comet Co.
- d) Issued credit memorandum for \$2,000 to Y Company for merchandise returned from sale in (b). The cost of the merchandise was \$1,200.
- e) Received amount due from X Company. within the discount period.
- f) Received amount due, less return and discount from Y Company
- g) Sold merchandise on account to X Company, \$5,000, terms FOB Shipping Point, 2/10, n/30. The cost of the merchandise sold was \$3,000. Paid transportation charges of \$200, which were added to the invoice.
- h) Sold merchandise on account to Y Company, \$10,000, terms FOB Destination, 1/10, n/30. The cost of the merchandise was \$6,000.
- i) Paid transportation charges of \$400 for delivery of merchandise sold to Comet Co.
- j) Issued credit memorandum for \$2,000 to Y Company for merchandise returned from sale in (b). The cost of the merchandise was \$1,200.
- k) Received amount due from X Company within the discount period.
- l) Received amount due, less return and discount from Y Company

Required: Prepare journal entries to record these transactions

True / False Questions

1. Sales Discounts is shown as a reduction of cost of goods sold in the income statement.
True False
2. A sale on account for \$1,000 offered with terms 2/10, n/30 means that the customers will get a \$2 discount if payment is made within 10 days; otherwise, full payment is due within 30 days.
True False
3. The Sales Discounts account is an expense account.
True False
4. A sales allowance is recorded as a debit to Accounts Receivable and a credit to Sales Allowances.
True False
5. The Sales Returns account is an expense account.
True False
6. If a company has total revenues of \$100,000, sales discounts of \$3,000, sales returns of \$4,000, and sales allowances of \$2,000, the income statement will report net revenues of \$91,000.
True False
7. For inventory that is shipped FOB destination, title transfers from the seller to the buyer once the seller ships the inventory.
True False
8. For inventory that is shipped FOB shipping point, title transfers from the seller to the buyer once the seller ships the inventory.
True False
9. Freight-in is included in the cost of inventory.
True False
10. Sales returns and allowances occur when the buyer returns the goods or the seller reduces the customer's balance owed.
True False

11. The contra-revenue accounts, Sales Returns and Allowances and Sales Discounts, should be closed by crediting these accounts and debiting Income Summary for each account.
True False
12. Merchandise inventory refers to products that a company owns and intends to sell to customers.
True False
13. Sellers always offer a discount to buyers for prompt payment toward purchases made on credit.
True False
14. Credit terms for a purchase include the amounts and timing of payments from a seller to a buyer.
True False
15. A merchandising company's operating cycle begins with the purchase of merchandise and ends with the collection of cash from the sale.
True False

Multiple Choice Questions

1. When purchases of merchandise are made on account, the transaction would be recorded with the following entry:
 - a) Debit Accounts Payable, credit Merchandise Inventory
 - b) Debit Merchandise Inventory, credit Accounts Payable
 - c) Debit Merchandise Inventory, credit Cash
 - d) Debit Cash, credit Merchandise Inventory
2. When a corporation sells merchandise and the terms are FOB shipping point and it pays the shipping costs, the seller would record the transportation costs with the following entry:
 - a) Debit Cash, credit Accounts Receivable
 - b) Debit Accounts Receivable, credit Sales
 - c) Debit Accounts Receivable, credit Cash
 - d) Debit Merchandise Inventory, credit Accounts Payable
3. A sales invoice included the following information: merchandise price \$12,000; transportation \$500; terms 2/10, n/eom, FOB shipping point. Assuming that \$600 of merchandise is returned prior to payment, that the seller pays the transportation and that the buyer pays the invoice within the discount period, what is the amount of cash received by the seller?
 - a) \$11,662
 - b) \$11,672
 - c) \$12,250
 - d) \$11,172
4. Merchandise with an invoice price of \$7,000 is purchased with terms of 2/10, n/30, FOB shipping point. Transportation costs paid by the seller were \$125. What is the cost of the merchandise purchased if payment is made during the discount period?
 - a) \$6,860.00
 - b) \$6,982.50
 - c) \$7,000.00
 - d) \$6,985.00

5. Cost of Merchandise Sold would be classified as:
 - a) Asset
 - b) Expense
 - c) Liability
 - d) Revenue

6. The discount period for credit terms of 1/10, n/30 is:
 - a) 1 day
 - b) 10 days
 - c) 20 days
 - d) 30 days

7. Freight costs incurred by the seller are recorded in the
 - a) Sales account
 - b) Cost of merchandise sold account
 - c) Transportation In account
 - d) Transportation Out account

8. The sales discount is based on
 - a) Invoice price plus transportation costs
 - b) Invoice price less discount
 - c) Invoice price plus transportation costs less returns and allowances
 - d) Invoice price less returns and allowances

9. M Company sold \$1,800 of merchandise on account on March 1 with credit terms of 2/10, n/30. \$500 of the merchandise was returned due to poor quality on March 3. If the purchase is paid for on March 11, what entry does M Company make to record receipt of the payment?
 - a) Debit Cash, \$1,764; credit A/R, \$1,764
 - b) Debit Cash, \$1,800; credit Sales Returns, \$500; credit A/R, \$1,300
 - c) Debit Cash, \$1,274; debit Sales Discounts \$26; credit A/R, \$1,300
 - d) Debit Cash, \$1,800; credit Sales Discounts \$36; credit A/R, \$1,764

10. Which of the following accounts is credited by the seller when merchandise purchases are paid for within the discount period?
 - a) Merchandise Inventory
 - b) Accounts Payable
 - c) Accounts Receivable
 - d) Sales Discounts

11. M Company sold \$1,800 of merchandise on account to O Company on March 1 with terms of 2/10, n/30. \$500 of the merchandise was returned on March 3. What entry does O Company make on March 12 to record the payment?
- a) Credit Cash, \$1,300; debit A/P, \$1,300
 - b) Credit Cash, \$1,800; debit A/P, \$1,800
 - c) Debit Cash, \$1,764; credit A/R, \$1,764
 - d) Debit Cash, \$1,800; credit A/P, \$1,800
12. A debit to Sales Returns and Allowances and a credit to Accounts Receivable:
- a) Reflects an increase in amount due from a customer.
 - b) Recognizes that a customer returned merchandise and/or received an allowance.
 - c) Requires a debit memorandum to recognize the customer's return.
 - d) Is recorded when a customer takes a discount.

The next 3 questions refer to the following information.

R Company reported the following results for the year:

Sales	\$4,000,000
Gross Profit	3,600,000
Net Income	1,080,000
Cash from Operating Activities	2,880,000

13. R Company's profit margin was:
- a) 90%
 - b) 30%
 - c) 27%
 - d) 72%
14. R Company's gross profit rate was:
- a) 90%
 - b) 30%
 - c) 27%
 - d) 72%
15. R Company's quality of earnings ratio was:
- a) .72
 - b) 2.7
 - c) 0.8
 - d) 1.4

Solutions to Practice Problems

Practice Problem #1

a) Merchandise Inventory	4,200	
A/P		4,200
b) A/P	500	
Merchandise Inventory		500
c) A/P	3,700	
Cash		3,630
Merchandise Inventory		70

Practice Problem #2

- a) Debit memo
- b) Shipping point
- c) Purchase returns
- d) Sales allowance
- e) Sales discount
- f) Credit memo
- g) Destination
- h) Credit terms
- i) Ending inventory
- j) Periodic

Practice Problem #3

a)	Merchandise Inventory	15,650	
	Accounts Payable		15,650
b)	Merchandise Inventory	8,000	
	Accounts Payable		8,000
c)	Accounts Receivable	9,800	
	Sales		9,800
	Cost of Merchandise Sold	5,800	
	Merchandise Inventory		5,800
d)	Accounts Payable/Cupid	2,000	
	Merchandise Inventory		2,000
e)	Accounts Payable	15,650	
	Cash		15,350
	Merchandise Inventory		300
	<i>(15,000 mdse * 2% = \$300 disc.)</i>		
f)	Sales Returns & Allowances	1,800	
	A/R		1,800
	Merchandise Inventory	1,080	
	Cost of Merchandise Sold		1,080
g)	Accounts Payable	6,000	
	Cash		5,940
	Merchandise Inventory		60
	<i>(8,000 - 2,000 return = 6,000 bal.)</i>		
	<i>(6,000 * 1% = \$60 discount)</i>		
h)	Cash	7,840	
	Sales Discount	160	
	A/R		8,000
	<i>(8,000 * 2% = \$160 discount)</i>		
	<i>(9,800 - 1,800 return = 8,000 bal.)</i>		
i)	Cost of Merchandise Sold	3,650	
	Merchandise Inventory		3,650
	<i>(85,000 - 81,350 = 3,650)</i>		

Practice Problem #4

a)	Accounts Receivable	5,200	
	Sales		5,000
	Cash		200
	Cost of Merchandise Sold	3,000	
	Merchandise Inventory		3,000
b)	Accounts Receivable	10,000	
	Sales		10,000
	Cost of Merchandise Sold	6,000	
	Merchandise Inventory		6,000
c)	Transportation Out	400	
	Cash		400
d)	Sales Returns & Allowances	2,000	
	Accounts Receivable		2,000
	Merchandise Inventory	1,200	
	Cost of Merchandise Sold		1,200
e)	Cash	5,100	
	Sales Discounts	100	
	Accounts Receivable/Jangle		5,200
	<i>\$5,000 sale * 2% = \$100 discount</i>		
	<i>\$5,200 owed (\$5,000 + \$200 shipping)</i>		
	<i>- \$100 discount = \$5,100 received</i>		
f)	Cash	7,920	
	Sales Discounts	80	
	Accounts Receivable/Comet		8,000
	<i>\$10,000 sale - \$2,000 return = \$8,000 owed</i>		
	<i>\$8,000 * 1% = \$80 discount</i>		
	<i>\$8,000 owed - \$80 discount = \$7,920 received</i>		

Solutions to True / False Problems

1. True
2. False - 2/10 indicates a 2% discount (or \$20 in this example) if payment is made within 10 days.
3. False - sales Discounts is a contra revenue account.
4. False - a sales allowance is recorded as a debit to Sales Allowances and a credit to Accounts Receivable.
5. False - sales Returns is a contra revenue account.
6. True
7. False - For FOB destination, title transfers once the inventory reaches the buyer (destination).
8. True
9. True
10. True
11. True
12. True
13. False – sellers do not always offer a cash discount for prompt payment
14. True
15. True

Solutions to Multiple Choice Questions

- | | |
|-----|---|
| 1. | B |
| 2. | C |
| 3. | B |
| 4. | D |
| 5. | B |
| 6. | B |
| 7. | D |
| 8. | D |
| 9. | C |
| 10. | C |
| 11. | A |
| 12. | B |
| 13. | C |
| 14. | A |
| 15. | B |