MERCHANDISING OPERATIONS

Key Topics to Know

Merchandising Businesses

- The revenue account is Sales, not Fees Earned
- New expense account, Cost of Goods Sold (COGS), records the cost of merchandise inventory sold to customers.
- COGS is the expense account associated with the asset account, Merchandise Inventory, just as Insurance Expense is the expense account associated with the asset account, Prepaid Insurance
- Accounting terms related to merchandising companies:
    - Merchandise Inventory
    - Perpetual inventory system
    - Periodic inventory system
    - Physical inventory

Inventory Method

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

Purchasing Transactions

- Recorded in inventory at purchase cost + freight-in (if FOB shipping point) – purchase returns and allowances – cash discounts
- Purchases are either FOB shipping point (Buyer records transportation costs) or FOB destination (Seller records transportation expense)
- Difference between a return and an allowance

Sales Transactions

- Recorded as a two-part transaction: a revenue part and an expense part
- Revenue part records sales and either cash or accounts receivable; the expense part records cost of goods sold and reduction of inventory.
- Net sales = Sales – sales discounts – sales returns and allowances

Credit Terms

- States the discount %, discount period in days and the payment period in days
- Reduce cost of inventory for the buyer and revenue for the seller
- Discount % is applied to only the cost of merchandise; never freight costs

Compute Gross Profit Rate, Profit Margin and Quality of Earnings Ratios

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.

Practice Problems

Problem #1 - Purchase related transaction

Merchandise is purchased on account from a supplier, List price $15,000, trade discount 40%, terms 2/10, n/30 FOB shipping point with transportation costs of $150 paid by the seller, and added to the invoice. The purchaser returned $1,000 of the merchandise prior to payment. The invoice was paid within the discount period.

Required: What is the amount of cash paid by the buyer?

Problem #2 - Sales related and purchase related transactions

Merchandise is sold on account to a customer for $15,000, terms 1/10, n/30, FOB destination. The merchandise cost $10,000. The seller paid transportation costs of $750. The buyer returned some of the merchandise and the seller prior to receiving payment issued a credit memorandum for $1,500 for returned merchandise. The returned merchandise cost $1,000.

Required:

a) What is the journal entry recorded by the seller for the sale of the merchandise?
b) What is the journal entry recorded by the seller for the return of the merchandise?
c) What is the journal entry recorded by the seller for the receipt of payment if the invoice is paid within the discount period?
d) What is the journal entry recorded by the buyer for the purchase of the merchandise?
e) What is the journal entry recorded by the buyer for the return of the merchandise?
f) What is the journal entry recorded by the buyer for the payment, if the invoice is paid within the discount period?

Problem #3 - Sales related transactions

During May, J Company had the following two transactions:

May 2	Sale of $ 1,000 of merchandise on a bank credit card (MasterCard). The cost of the merchandise is $600.
May 7	Sale of $500 of merchandise on account on a non-bank credit card (American Express), when the sale is subject to a sales tax of 8% and the merchandise cost $300.

Required: Prepare the necessary journal entries to record these transactions.

Problem #4 - Purchase related transactions

S Company uses a perpetual inventory system and purchased $17,800 of merchandise on April 7 with credit terms of 1/10, n/30. Merchandise with a cost of $1,800 was damaged and returned to the seller on April 10. On April 16 the company paid the amount due. Prepare the journal entries to record the transactions on all three dates.

Required: Prepare the necessary journal entries to record these transactions.

Multiple Choice Questions

1. Which account listed below is classified as a contra-revenue account?
   a) Cost of Goods Sold.
   b) Gross profit
   c) Sales Discounts
   d) Purchases.

2. Sales revenue is recognized in the period in which:
   a) Merchandise is delivered to the customer.
   b) The customer orders the merchandise.
   c) Cash payment is received by the seller.
   d) Purchases are made to replace the merchandise sold.

3. Cost of goods sold:
   a) Is the term used for the expense of buying and preparing merchandise for sale.
   b) Is the expense account associated with inventory
   c) Is used in calculating gross margin
   d) All of the above

4. The following statements regarding merchandise inventory are true *except*:
   a) Merchandise inventory refers to products a company owns and intends to sell.
   b) Merchandise inventory appears on the balance sheet of a service company.
   c) Merchandise inventory may include the costs of freight in and making them ready for sale.
   d) Purchasing merchandise inventory is part of the operating cycle for a business.

5. A cash discount is:
   a) A term used by a seller to describe a cash discount granted to customers for prompt payment.
   b) A reduction in selling price below the list price.
   c) A term used by a purchaser to describe a cash discount given to customers for prompt payment.
   d) A reduction in price for prompt payment.

6. J Company purchased $1,800 of merchandise on July 5 with terms 2/10, n/30. On July 7, it returned $200 worth of merchandise. On July 28, it paid the full amount due. The correct journal entry to record the merchandise return on July 7 is:
   a) Debit Merchandise Inventory $200; credit Sales Returns $200.
   b) Debit Accounts Payable $200; credit Merchandise Inventory $200.
   c) Debit Merchandise Inventory $200; credit Sales $200.
   d) Debit Accounts Payable $1,800; credit Purchase Returns $200; credit Merchandise Inventory $1,600.

7. Sales returns:
   a) Refer to merchandise that customers return to the seller after the sale.
   b) Represent cash discounts.
   c) Are not recorded under the perpetual inventory system until the end of each accounting period.
   d) Refer to reductions in the selling price of merchandise sold to customers.

Use the following information to answer the next 3 questions:
J Company uses a *perpetual* inventory system. The company purchased $9,750 of merchandise on August 7 with terms 2/10, n/30. On August 11, it returned $1,500 worth of merchandise. On August 26, it paid the full amount due.

8. The net amount debited to the purchases account is:
   a) $8,085
   b) $8,250
   c) $9,750
   d) $0

9. The correct journal entry to record the merchandise return on August 11 is:
   a) Debit Merchandise Inventory $1,500; credit Sales Returns $1,500.
   b) Debit Accounts Payable $1,500; credit Purchase Returns $1,500.
   c) Debit Accounts Payable $1,500; credit Merchandise Inventory $1,500.
   d) Debit Accounts Payable $1,500; credit Cash $1,500.

10. The cash paid on August 28 was:
   a) $8,085
   b) $8,250
   c) $9,750
   d) $8,415

The next 3 questions refer to the following information.
L Company reported the following results for the year:

Sales	$2,000,000
Gross Profit	900,000
Net Income	360,000
Cash from Operating Activities	720,000

11. L Company's profit margin was:
    a) 45%
    b) 40%
    c) 18%
    d) 36%

12. L Company's gross profit rate was:
    a) 45%
    b) 40%
    c) 18%
    d) 36%

13. L Company's quality of earnings ratio was:
    a) .36
    b) 2.0
    c) 2.8
    d) 1.8

14. A debit memorandum is:
    a) The source document for the purchase of merchandise inventory.
    b) The document a buyer issues to inform the seller of a debit made to the seller's account in the buyer's records.
    c) Required when a purchase discount is granted.
    d) Not necessary in a perpetual inventory system.

15. A Company purchased $1,800 of merchandise on July 5 with terms 2/10, n/30. On July 7, it returned $200 worth of merchandise. On July 28, the cash paid is:
    a) $1,600
    b) $200
    c) $1,800
    d) $1,568

Solutions to Practice Problems

Problem #1 - Purchase related transaction

List price for merchandise	$15,000
Less Trade discount of 40%	(6,000)
Invoice amount	9,000
Less return	(1,000)
Amount subject to discount	8,000
Less 2% cash discount	160
	7,840
Plus transportation	150
Amount paid by the buyer	$7,990

Problem #2 - Sales related and purchase related transactions

a. Journal entry recorded by the seller for the sale of the merchandise:

Accounts Receivable	15,000	
Sales		15,000
Cost of Merchandise Sold	10,000	
Merchandise Inventory		10,000
Transportation Out	750	
Cash		750

b. Journal entry recorded by the seller for the return of the merchandise:

Sales Returns and Allowances	1,500	
Accounts Receivable		1,500
Merchandise Inventory	10,000	
Cost of Merchandise Sold		10,000

c. Journal entry recorded by the seller for the receipt of payment:

Cash	13,365	
Sales Discounts	135	
Accounts Receivable		13,500

d. Journal entry recorded by the buyer for the purchase of the merchandise:

Merchandise Inventory	15,000	
Accounts Payable		15,000

e. Journal entry recorded by the buyer for the return of the merchandise:

Accounts Payable	1.500	
Merchandise Inventory		1,500

f. Journal entry recorded by the buyer for the payment:

Accounts Payable	13,500	
Merchandise Inventory		135
Cash		13,365

Problem #3 - Sales related transactions

a. Sale of $1,000 of merchandise for cash or bank credit card, the cost of the merchandise is $600.

Cash	1,000	
Sales		1,000
Cost of Merchandise Sold	600	
Merchandise Inventory		600

b. Sale of $500 of merchandise on account or a non-bank credit card, when the sale is subject to a sales tax of 8% and the merchandise cost $300.

Accounts Receivable	540	
Sales		500
Sales Tax Payable		40
Cost of Merchandise Sold	300	
Merchandise Inventory		300

Problem #4 - Purchase related transactions

April 7	Merchandise Inventory	17,800	
	Accounts Payable		17,800
April 10	Accounts Payable	1,800	
	Merchandise Inventory		1,800
April 16	Accounts Payable	16,000	
	Merchandise Inventory		160
	Cash		15,840

Solutions to Multiple Choice Questions

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