Financial Accounting
Chapter 6
Accounting for Merchandising Businesses

I. Introduction

A. We now want to look at accounting for a merchandising business
   1. Those that buy goods and resell them
   2. Accounting cycle is basically the same -- uses some different accounts
   3. Note, Income Statement on page 239
   4. Balance sheet reports "inventory"
   5. See Exhibit 6 on page 238 for highlighted differences in the chart of accounts.

II. Cost of Goods Sold
   A. Represents what it cost you to acquire goods you sold this period.
   B. What about goods acquired but not sold?
      1. This is an asset called "Merchandise Inventory"
      2. Two types of systems to account for inventory
         a. Perpetual -- keep a constant balance of inventory on hand (updates inventory account when merchandise is bought and sold, hence we also continually update COGS)
         b. Periodic -- do not keep a running balance of inventory on hand. Must make periodic physical count.

         (1) When goods are bought use "purchases" account (recorded from purchase invoice)
         (2) Cost of Goods Sold is a residual amount
         (3) Formula for Cost of Goods Sold (COGS)
              Beginning Inventory
              + Purchases (Net)  (Cost of Goods Purchased =
              + Transportation-In  Net Purchases + Transportation-In)
              -----------------------------
              Goods Available for Sale
              - Ending Inventory
              -----------------------------
              Cost of Goods Sold
C. Accounting for typical transactions of a merchandising company.

1. Acquisition of goods for resale

   Perpetual
   Merchandise Inventory       XX
   Cash or A/P                  XX

   Periodic
   Purchases                   XX
   Cash or A/P                  XX

2. Purchases Returns and Allowances
   a. Unsatisfactory merchandise returned by buyer or price adjustment.
      Perpetual
      Cash or A/P                  XX
      Merchandise Inventory        XX

      Periodic
      Cash or A/P                  XX
      Purchases Returns and Allowances  XX
   b. Issuance of debit memorandum by buyer

3. Purchases discounts
   a. Discounts we take on the items we purchase—supplier offers such discounts to encourage early payment.
   b. Credit terms—net 30; 2/10, n/30; 1/10, n/com
   c. Very important to take advantage of

   \[
   \text{Approx cost of not taking} = \frac{\text{Discount}}{1-\text{Discount}} \times \frac{1}{\text{Credit Period-Discount Period}}
   \]

   d. Discounts are only available on items purchased and not returned.
   e. Recorded when invoice is paid—gross method.

      Perpetual
      Accounts Payable—vendor     XX
      Cash                         XX
      Merchandise Inventory        XX

      Periodic
      Accounts Payable—vendor     XX
      Purchases Discount           XX
      Cash                         XX
f. Net method—record the initial purchases amount at the “net” amount. Invoices not paid timely are debited to “purchase discounts lost.”
g. Trade discounts—deduction allowed from list or catalog price

4. Freight costs. Costs to get merchandise to buyers place of business
   a. F.O.B. Shipping Point
      
      Perpetual
      Merchandise Inventory
      XX
      XXX
      Cash
      XXX

      Periodic
      Transportation-In
      XX
      XXX
      Cash
      XXX

   b. F.O.B. Destination
      
      Perpetual or Periodic
      Delivery Expense (Transportation-out)
      XX
      XXX
      Cash
      XXX

III. Analysis of revenues from Sales

A. Gross Sales
   1. Both cash and credit sales (merchandise held for resale)
      a. Bank credit card sales are treated as cash sales.
   2. Recorded when earned -- when title passes
   3. Typical journal entry
      
      Cash
      XX
      Accounts Receivable
      XX
      Retail Price
      Merchandise Inventory
      XXX
      Sales
      XXX

   4. If perpetual inventory system is used, also record cost of goods sold
      Cost of Goods Sold
      XX
      Merchandise Inventory
      XXX

   5. Sales taxes are recorded as liabilities; this is not additional revenue.

B. Sales Returns and Allowances
   1. Records return of unsatisfactory goods and/or reductions in sales prices
      (Issue credit memo)
   2. Contra Revenue
   3. Typical Journal Entry
      
      Periodic
Sales Returns and Allowances
Accounts receivable
and/or Cash

Perpetual
Sales Returns and Allowances
Accounts receivable
and/or Cash
Merchandise Inventory
COGS

C. Sales Discounts
1. Amount you allow your customers to subtract from payment to encourage early payment
2. Credit terms govern discount allowed
3. Typical transaction sequence -- Assume we sell $100 Merchandise -- terms 2/10, n/30

4. Contra Revenue

D. Net Sales =
1. Gross Sales less Sales Return and Allowances less Sales discount

E. Introduction to Subsidiary Ledgers
1. What does the balance in the Accounts Receivable account represent??
   a. What does balance in Accounts Payable represent?

2. Accounts Receivable Subsidiary Ledger
   a. Separate ledger from General Ledger
   b. Contains an account for each customer we sell on credit to!!

3. Accounts Payable Subsidiary Ledger--same concepts for Accounts Payable--each vendor from which we buy on credit.

4. Concept of Controlling account.

IV. Gross Profit on Sales
A. Net Sales less COGS
B. Also commonly called Gross Margin
C. Gives you an idea of average markup on goods sold

V. Operating Expenses
A. Expenses other than COGS
B. Broad Classifications
   1. Selling
   2. General and Administrative

VI. Worksheet for Merchandising Company
   A. If perpetual inventory system is used, adjust inventory shrinkage through cost of goods sold.
   B. Under periodic system use adjusting entry approach for inventory
      1. Get out old balance--adjust through income summary
      2. Put in new balance--adjust through income summary
   C. Merchandise inventory is an asset -- extend to Balance Sheet column
   D. The other new accounts -- extend to Income Statement
   E. Note -- Income summary will have both a Debit AND Credit extension in the income statement columns if periodic inventory system is used.

VII. Closing Entries
    A. Same as before -- Revenue Income Summary
       Expense Withdrawals
       B. The "NEW" accounts--other than merchandise inventory must be closed.

VIII. Income Statement Formats
    A. Single Step
       1. Net income determined in one step --> revenues - expenses
    B. Multiple Step
       1. Shows several intermediate subtotals in arriving at net income
          a. Gross profit
          b. Selling expenses
          c. G & A expenses
          d. Income from operations
          e. Other income and expenses