Accounting for Merchandising Business

Prepare the entry PW Audio Supply would make to record the credit for returned goods that had a $300 selling price with a $140 cost. The goods were not defective.

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
	Inventory	140	
	Cost of Goods Sold		140

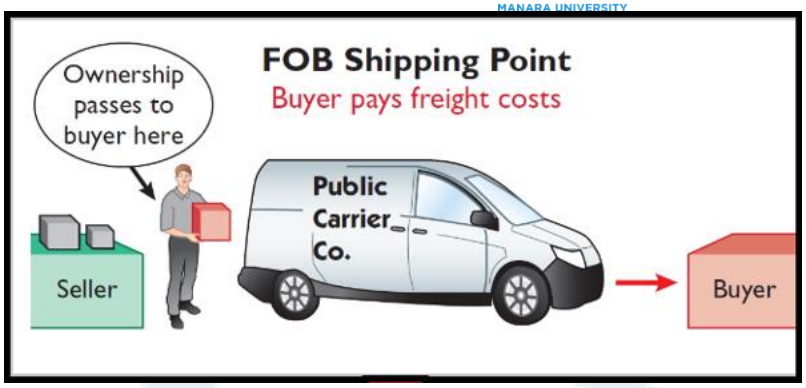
Assume the returned goods were defective and had a scrap value of $50, PW Audio would make the following entries:

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
	Inventory	50	
	Cost of Goods Sold		50

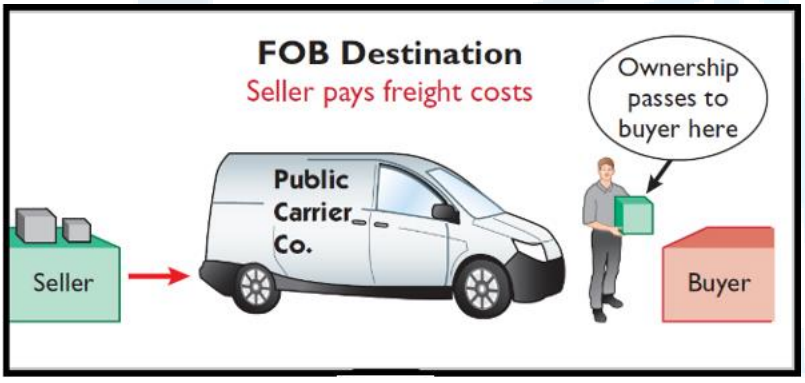
Example

On September 5, De La Hoya Company buys merchandise on account from Junot Diaz Company. The selling price of the goods is $1,500, and the cost to Diaz Company was $800. On September 8, De La Hoya returns defective goods with a selling price of $200 and a fair value of $30. Record the sale on the books of Junot Diaz Company.

Freight



Ownership of the goods passes to the buyer when the public carrier accepts the goods from the seller.



Ownership of the goods remains with the seller until the goods reach the buyer.

Freight costs incurred by the seller are an **operating expense**.

Assume upon delivery of the goods on May 6, **Sauk Stereo pays** Public Freight Company $150 for **freight charges**, the entry on Sauk Stereo's books is:

May 6	Inventory	150	
	Cash		150

If the freight terms had required **PW Audio Supply to pay** the freight charges, the entry by PW Audio Supply would be:

May 4	Freight-Out (or Delivery Exp)	150	
	Cash		150

Assume that on June 10, NetSolutions purchased merchandise as follows:

June	10	Purchased merchandise from Magna Data, $900, terms FOB shipping point
		Paid freight of $50 on June 10 purchase from Magna Data.

Trade Discounts

- Wholesalers are companies that sell merchandise to other businesses rather than to the public.
- In addition, wholesalers often offer special discounts to government agencies or businesses that order large quantities.

Such discounts are called **trade discounts**

- For example, assume that an item has a list price of $1,000 and a 40% trade discount. The seller and buyer records the sale of the item at $600 [$1,000 less the trade discount of $400 ($1,000 × 40%)]. Likewise, the buyer records the purchase the purchase at $600.

Adjusting Entry for Inventory Shrinkage

- Under the perpetual inventory system, the merchandise inventory account is continually updated for purchase and sales transactions.
- As a result, the balance of the merchandise inventory account is the amount of merchandise available for sale at that point in time.
- Thus, the physical inventory on hand at the end of the accounting period is usually less than the balance of Merchandise Inventory.

This difference is called **inventory shrinkage** or **inventory shortage**

- After the entry is recorded, the balance of Merchandise Inventory agrees with the physical inventory on hand at the end of the period.

To illustrate, **Net Solutions**' inventory is as follows on December 31, 2020:

Account balance of Merchandise Inventory	$63,950
Physical inventory on hand	62,150
Inventory shrinkage	$ 1,800

At the end of the accounting period, inventory shrinkage is recorded by the following adjusting entry:

		Adjusting Entry			
Dec.	31	Cost of Merchandise Sold	1,800		
		Merchandise Inventory		1,800	
		Inventory shrinkage ($63,950 – $62,150).			

Pulmonary Company's perpetual inventory records indicate that $382,800 of merchandise should be on hand on March 31, 2019. The physical inventory indicates that $371,250 of merchandise is actually on hand. Journalize the adjusting entry for the inventory shrinkage for Pulmonary

Company for the year ended March 31, 2019. Assume that the inventory shrinkage is a normal amount.

Adjusting Entry for Customer Refunds, Allowances, and Returns

- Sellers are required to estimate returns and allowances at the end of an accounting period and prepare two adjusting entries:
    1. The first adjusting entry reduces the sales account and creates a customer refund liability account for the estimated refunds and allowances that will be granted to customers in the future.
    2. The second adjusting entry creates an estimated returns inventory account for the cost of merchandise that is expected to be returned and reduces cost of merchandise sold.
- Estimated Returns Inventory is debited rather than Merchandise Inventory because the type of merchandise returned will not be known until the returns actually occur.

On January 1, Rainbow Company sells 100 pairs of shoes for $100 each on account to Tanner Inc. Rainbow allows Tanner to return any unused shoes within 45 days of purchase. The cost of each product is $60. Rainbow records the sale as follows.

Jan. 1	Accounts Receivable	10,000	
	Sales Revenue		10,000
	Cost of Goods Sold	6,000	
	Inventory		6,000

On January 24, Tanner returns two pairs of shoes with a selling price of $100 each and a cost of $60 each because they were the wrong color. Rainbow records the return as follows.

Jan. 24	Sales Returns and Allowances	200	
	Accounts Receivable		200
	Inventory	120	

	Cost of Goods Sold		120

On January 31, Rainbow prepares monthly financial statements and estimates that it is likely that one more pair of shoes will be returned. The selling price is $100 per pair with a unit cost of $60. Rainbow records two adjusting entries to account for this estimate.

Jan. 31	Sales Returns and Allowances	100	
	Allowance for Sales Returns and Allowances		100
	Estimated Inventory Returns	60	
	Cost of Goods Sold		60

On February 18, Tanner returns another pair of shoes to Rainbow. The selling price is $100 per pair with a unit cost of $60. If Tanner has not already paid Rainbow for the shoes, Rainbow records the entry as follows.

Feb. 18	Allowance for Sales Returns and Allowances	100	
	Accounts Receivable		100
	Inventory	60	
	Estimated Inventory Returns		60

Example

Pulmonary Company's perpetual inventory records indicate that $382,800 of merchandise should be on hand on March 31, 2019. The physical inventory indicates that $371,250 of merchandise is actually on hand. Journalize the adjusting entry for the inventory shrinkage for Pulmonary Company for the year ended March 31, 2019. Assume that the inventory shrinkage is a normal amount.

Financial Statements

- Although merchandising transactions affect the balance sheet in reporting inventory, they primarily affect the income statement.
- An income statement for a merchandising business is normally prepared using either a multiple-step or single-step format.

Multiple-Step Income Statement

- The **multiple-step income statement** contains several sections, subsections, and subtotals, including the following:
    - Sales
    - Cost of Merchandise Sold
    - Gross Profit
    - Income from Operations
    - Other Income and Expense
- Operating expenses are normally classified as either selling expenses or administrative expenses.
    - **Selling expenses** are incurred directly in the selling of merchandise. Examples of selling expenses include the following:
        - Sales salaries
        - Store supplies used
        - Depreciation of store equipment
        - Delivery expense
        - Advertising
    - Administrative expenses, sometimes called general expenses, are incurred in the administration or general operations of the business. Examples of administrative expenses include the following:
        - Office salaries
        - Depreciation of office equipment
        - Office supplies used
- Other income and expense items are not related to the primary operations of the business.

- Other income is revenue from sources other than the primary operating activity of a business. Examples of other income include the following:
    - Income from interest
  - Rent
  - Gains resulting from the sale of fixed assets
- Other expense is an expense that cannot be traced directly to the normal operations of the business. Examples of other expenses include the following:
  - Interest expense
  - Losses from disposing of fixed assets

Single-Step Income Statement

The single-step form deducts the total of all expenses in one step from the total of all revenues. Prepare the operating and nonoperating sections of the income statement from the following information

Sales Commissions	$ 24,000
Officers' Salaries	15,000
Interest Revenue	7,000
Dividend Revenue	5,000
Loss on Sale of Investment (unusual)	(8,000)
Net Sales	240,000
Cost of Goods Sold	160,000

Solution

Net Sales		$ 240,000
Cost of Goods Sold		(160,000)
Gross Profit		$ 80,000
Selling Expenses:		
Sales Commissions		(24,000)
Administrative Expenses:		
Officers' Salaries		(15,000)
Income from Operating Activities		$ 41,000
Other Revenue and Gains:		
Interest Revenue	$7,000	
Dividend Revenue	5,000	12,000
Other Expenses and Losses:		
Unusual Loss on Sale of Investment		(8,000)
Income from Continuing Operations before Taxes		$ 45,000

The Operating Section, the Nonoperation Section, and the Tax Section

Frisch Corporation had the following items relating to its income statement for 19X1:

Merchandise Inventory, Jan. 1	$40,000	Sales	$100,000
Merchandise Inventory, Dec. 31	20,000	Sales Returns	2,000
Transportation In	2,000	Sales Discounts	4,000
Purchases Returns	3,000	Purchases Discounts	5,000
Purchases	50,000		

Determine the following:

- **Net sales**
- **Net purchases**
- **Goods available for sale**
- **Cost of goods sold**

The Closing Process

- The closing entries for a merchandising business are similar to those for a service business. The two closing entries for a merchandising business are as follows:
  - Debit each revenue account for its balance, credit each expense account for its balance, and credit owner's capital account for net income. Debit the owner's capital account for a net loss. Cost of merchandise sold is a temporary account and is closed like an expense account.

- Debit the owner's capital account for the balance of the drawing account and credit the drawing account.

Periodic Inventory System

Under the periodic inventory system, purchases are normally recorded at their invoice amount.

If the invoice is paid within the discount period, the discount is recorded in a separate account called Purchases Discounts.

Likewise, purchase returns are recorded in a separate account called Purchase Returns and Allowances.

At the end of the period, a physical count of merchandise inventory on hand is taken.

This physical count is used to determine the cost of merchandise sold.

A separate purchases returns and allowances account is used to record returns and allowances.

Purchases returns and allowances are reported as a deduction from Purchases for the period.

Under the periodic inventory system, freight paid when purchasing merchandise FOB shipping point is debited to Freight In, Transportation In, or a similar account.

Transaction	Periodic Inventory System		
June 5. Purchased $30,000 of merchandise on account, terms 2/10, n/30.	Purchases	30,000	
	Accounts Payable		30,000
June 8. Returned merchandise purchased on account on June 5, $500.	Accounts Payable	500	
	Purchases Returns and Allowances		500
June 15. Paid for purchase of June 5, less return of $500 and discount of $590 [($30,000 – $500) × 2%].	Accounts Payable	29,500	
	Cash		28,910
	Purchases Discounts		590
June 18. Sold merchandise on account, $12,500, 1/10, n/30. The cost of the merchandise sold was $9,000.	Accounts Receivable [$12,500 – ($12,500 × 1%)]	12,375	
	Sales		12,375
June 22. Purchased merchandise, $15,000, terms FOB shipping point, 2/15, n/30, with prepaid freight of $750 added to the invoice.	Purchases	15,000	
	Freight In	750	
	Accounts Payable		15,750
June 28. Received payment on account from June 18 sale.	Cash	12,375	
	Accounts Receivable		12,375
June 29. Received $19,600 from cash sales. The cost of the merchandise sold was $13,800.	Cash	19,600	
	Sales		19,600

Under the perpetual inventory system, the ending inventory physical count is compared to the balance of Merchandise Inventory.

- The difference is the amount of inventory shrinkage.
- The inventory shrinkage is then recorded as a debit to Cost of Merchandise Sold and a credit to Merchandise Inventory.

The closing entries differ in the periodic inventory system in that there is no cost of merchandise sold account to close to Income Summary.

- Instead, the purchases, purchases discounts, purchases returns and allowances, and freight in accounts are closed to Income Summary.
- In addition, the merchandise inventory account is adjusted to the end-of-period physical inventory count during the closing process.

The two closing entries under the periodic inventory system are as follows:

- Debit Merchandise Inventory for its end-of-period balance based on the physical inventory.
- Debit Estimated Returns Inventory for the cost of the future estimated returns of the current period's sales.
- Debit each revenue account and the following temporary periodic inventory accounts for their balances.
  - Purchases Discounts
  - Purchases Returns and Allowances
- Credit Merchandise Inventory for its balance as of the beginning of the period.
- Credit each expense account and the following temporary periodic inventory accounts for their balances.
  - Purchases
  - Freight In
- Credit the owner's capital account (Chris Clark, Capital) for the net income. Debit the owner's capital account for a net loss.

BE5-1 Presented below are the components in Gates Company's income statement. Determine the missing amounts

	Sales Revenue	Cost of Goods Sold	Gross Profit	Operating Expenses	Net Income
(a)	$75,000	?	$30,000	?	$10,800
(b)	$108,000	$70,000	?	?	$29,500
(c)	?	$83,900	$79,600	$39,500	?

BE5-2 Radomir Company buys merchandise on account from Lemke Company. The selling price of the goods is $780, and the cost of the goods is $470. Both companies use perpetual inventory systems. Journalize the transaction on the books of both companies.

BE5-3 Prepare the journal entries to record the following transactions on Kwang Company's books using a perpetual inventory system.

A. On March 2, Kwang Company sold $900,000 of merchandise to Sensat Company, terms 2/10, n/30. The cost of the merchandise sold was $620,000.
B. On March 6, Sensat Company returned $90,000 of the merchandise purchased on March 2. The cost of the returned merchandise was $62,000.
C. On March 12, Kwang Company received the balance due from Sensat Company.

BE5-4 From the information in BE5-3, prepare the journal entries to record these transactions on Sensat Company's books under a perpetual inventory system.

BE5-5 At year-end, the perpetual inventory records of Litwin Company showed merchandise inventory of $98,000. The company determined, however, that its actual inventory on hand was $95,700. Record the necessary adjusting entry.

BE5-6 Hudson Company has the following account balances: Sales Revenue $195,000, Sales Discounts $2,000, Cost of Goods Sold $117,000, and Inventory $40,000. Prepare the entries to record the closing of these items to Income Summary.

BE5-7 Arndt Company provides the following information for the month ended October 31, 2015: sales on credit $280,000, cash sales $100,000, sales discounts $5,000, and sales returns and allowances $11,000. Prepare the sales section of the income statement based on this information.

BE5-8 Explain where each of the following items would appear on (1) a multiplestep income statement, and on (2) a single-step income statement: (a) gain on sale of equipment, (b) interest

expense, (c) casualty loss from vandalism, and (d) cost of goods sold. $11,000. Prepare the sales section of the income statement based on this information.

BE5-8 Explain where each of the following items would appear on (1) a multiplestep income statement, and on (2) a single-step income statement: (a) gain on sale of equipment, (b) interest expense, (c) casualty loss from vandalism, and (d) cost of goods sold.

BE5-9 Assume Kader Company has the following reported amounts: Sales revenue $510,000, Sales returns and allowances $15,000, Cost of goods sold $330,000, and Operating expenses $110,000. Compute the following: (a) net sales, (b) gross profi t, (c) income from operations, and (d) gross profit rate. (Round to one decimal place.)

B E5-11 Assume that Gallant Company uses a periodic inventory system and has these account balances: Purchases $450,000, Purchase Returns and Allowances $13,000, Purchase Discounts $8,000, and Freight-In $16,000. Determine net purchases and cost of goods purchased.

B E5-12 Assume the same information as in BE5-11 and also that Gallant Company has beginning inventory of $60,000, ending inventory of $90,000, and net sales of $730,000. Determine the amounts to be reported for cost of goods sold and gross profit.

B E5-13 Prepare the journal entries to record these transactions on Nimmer Company's books using a periodic inventory system.

- On March 2, Nimmer Company purchased $900,000 of merchandise from Sen Company, terms 2/10, n/30.
- On March 6, Nimmer Company returned $130,000 of the merchandise purchased on March 2.
- On March 12, Nimmer Company paid the balance due to Sen Company.

BE5-14 A. Hall Company has the following merchandise account balances: Sales Revenue $180,000, Sales Discounts $2,000, Purchases $120,000, and Purchases Returns and Allowances $30,000. In addition, it has a beginning inventory of $40,000 and an ending inventory of $30,000. Prepare the entries to record the closing of these items to Income Summary using the periodic inventory system.

E5-3 On September 1, Boylan Offi ce Supply had an inventory of 30 calculators at a cost of $18 each. The company uses a perpetual inventory system. During September, the following transactions occurred.

Sept	6	. Purchased with cash 80 calculators at $20 each from Guthrie Co.
	9	Paid freight of $80 on calculators purchased from Guthrie Co.
	10	Returned 3 calculators to Guthrie Co. for $63 credit (including freight) because they did not meet specifi cations.
	12	Sold 26 calculators costing $21 (including freight) for $31 each to Lee Book Store, terms n/30.
	14	Granted credit of $31 to Lee Book Store for the return of one calculator that was not ordered.
	20	Sold 30 calculators costing $21 for $32 each to Orr's Card Shop, terms n/30.

Instructions Journalize the September transactions.

E5-7 Juan Morales Company had the following account balances at year-end: Cost of Goods Sold $60,000, Inventory $15,000, Operating Expenses $29,000, Sales Revenue $115,000, Sales Discounts $1,200, and Sales Returns and Allowances $1,700. A physical count of inventory determines that merchandise inventory on hand is $13,900.

Instructions

A. Prepare the adjusting entry necessary as a result of the physical count.

B. Prepare closing entries.

E5-9 Presented below is information for Furlow Company for the month of March 2015

Cost of goods sold	$212,000	Rent expense	$ 32,000
Freight-out	7,000	Sales discounts	8,000
Insurance expense	6,000	Sales returns and allowances	13,000
Salaries and wages expense	58,000	Sales revenue	380,000

Instructions

A. Prepare a multiple-step income statement.

B. Compute the gross profit rate.