

# Chapter 5

Thursday, January 14, 2016

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## Inventory System

- Merchandising involves purchasing products (inventory) to resell to customers
- A merchandising company keeps track of its inventory to determine what is available for sale (inventory) and what has been sold (cost of goods sold)
- Two systems to account for inventory:
  - Perpetual
  - Periodic

### Perpetual

- Detailed records of the cost of each inventory purchased and sale are maintained
- Cost of goods sold is determined each time a sale occurs
- Inventory records are up-to-date and provide timely information to management

### Periodic

- Detailed records are not kept throughout the period
- Cost of goods sold determined only at the end of the accounting period
- The physical inventory count at the end of the accounting period determines ending inventory

## Records purchases of Merchandise

### Purchases

	<b>Perpetual</b>	<b>Periodic</b>
1.	<b>Dr. Merchandise Inventory</b> Cr. Cash or A/P	<b>Dr. Purchases</b> Cr. Cash or A/P

### 2. Sales Taxed

for

- GST,PST,HST.
- Do not form part of the cost of the merchandise

### 3. Freight costs

- Costs of transporting the goods to the buyer's place of business
- Freight terms state who pays the freight charges

#### FOB Shipping point

- Goods are delivered by the seller to the point of shipping
- The buyer pays the freight costs to get the goods from the point of shipping to the destination
- The buyer is responsible for any damage that may occur along the way
- Freight cost is part of the cost of purchasing the inventory

#### FOB destination

- Goods are delivered by the seller to their destination
- The seller pays the freight costs to get the goods from the point of shipping to the destination
- The seller is responsible for any damage that may occur along the way
- Freight cost is an operating expense for the seller

#### FOB shipping point:

Journal entry for the buyer

Perpetual	Periodic
Dr. Merchandise inventory Cr. Cash or A/P	Dr. Freight in Cr. Cash or A/P

### 4. Purchase returns and allowances

- Purchase return:
  - The buyer returns the goods to the seller and receives a cash fund or credit
- Purchase allowance:
  - The seller gives an allowance (deduction) from the purchase price

Perpetual	Periodic
Dr. Cash or A/P Cr. Merchandise inventory	Dr. Cash or A/P Cr. Purchase returns and allowances

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## 5. Discounts

- **Quantity discount:**

- Gives a price reduction according to the volume of the purchase
- Not recorded separately - discounted price is recorded as cost of purchase

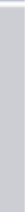
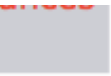
- **Purchase discount:**

- Offered to encourage early payment of a balanced due.
- Example: 2/10, n/30
- Recorded separately when payment is made

	Perpetual	Periodic
○	Dr. A/P Cr. Cash <b>Cr. Merchandise inventory</b>	Dr. A/P Cr. Cash <b>Cr. Purchase discounts</b>

### SUMMARY.

Transaction	perpetual	periodic
Purchase of merchandise	<b>Dr. Merchandise inventory</b> Cr. Cash or A/P	<b>Dr. Purchases</b> Cr. Cash or A/P
Freight on merchandise purchased (FOB shipping)	<b>Dr. Merchandise inventory</b> Cr. Cash or A/P	<b>Dr. Freight in</b> Cr. Cash or A/P
Return of purchased merchandise	Dr. Cash or A/P <b>Cr. Merchandise inventory</b>	Dr. Cash or A/P <b>Cr. Purchase returns and allowances</b>
Paying creditors on account within discount period	Dr. A/P <b>Cr. Merchandise inventory</b> Cr. Cash	Dr. A/P <b>Cr. Purchase discounts</b> Cr. Cash



## 1. Sales

Perpetual	Periodic
Dr. Cash or A/R Cr. Sales (to record the sale)	Dr. Cash or A/R Cr. Sales (to record the sale)
Dr. Cost of goods sold Cr. Merchandise inventory (to record the cost of merchandise sold)	No entry

**COGS:** total cost of the merchandise that was sold during the period

## 2. Sales Taxes

- Are collected on behalf of the federal and the provincial governments and must be periodically remitted to these authorities
- Are not recorded as revenue, but recorded as a liability (e.g. sales taxes payable) until are paid to the government

## 3. Freight costs

- If FOB destination point:
  - Freight charges are paid by the seller
  - The seller prepares the following entry

Perpetual	Periodic
Dr. Freight out Cr. Cash or A/P	Dr. Freight out Cr. Cash or A/P

## 4. Return of sold merchandise

- The Seller:
  - Returns cash to the buyer, or
  - Reduces the buyer's accounts receivable
- Use of a contra revenue account: sales returns and allowances.

Perpetual	Periodic
Dr. Sales returns and allowances Cr. Cash or A/R (to record return of goods)	Dr. Sales returns and allowances Cr. Cash or A/R (to record return of goods)

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| <b>Dr. Merchandise inventory</b><br><b>Cr. Cost of goods sold</b><br><b>(to record cost of goods returned)</b> | <b>No entry</b> |
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## 5. Discounts

- Quantity discount:
  - No separate entry is made
- Sales discount:
  - Use sales discount account:
    - Contra revenue: account to sales
    - Normal balance: debit

	<b>Perpetual</b>	<b>Periodic</b>
○	<b>Dr. Freight out</b> <b>Cr. Cash or A/P</b>	<b>Dr. Freight out</b> <b>Cr. Cash or A/P</b>

## SUMMARY.

<b>Transaction</b>	<b>Perpetual</b>	<b>Periodic</b>
Sale of merchandise	<b>Dr. Cash or A/R</b> <b>Cr. Sales</b>	<b>Dr. Cash or A/R</b> <b>Cr. Sales</b>
	<b>Dr. Cost of goods sold</b> <b>Cr. Merchandise inventory</b>	<b>No entry</b>
Freight (FOB destination)	<b>Dr. Freight out</b> <b>Cr. Cash or A/P</b>	<b>Dr. Freight out</b> <b>Cr. Cash or A/P</b>
Return of sold merchandise	<b>Dr. Sales returns and allowances</b> <b>Cr. Cash or A/R</b>	<b>Dr. Sales returns and allowances</b> <b>Cr. Cash or A/R</b>
	<b>Dr. Merchandise inventory</b> <b>Cr. Cost of goods sold</b>	<b>No entry</b>
Collection of	<b>Dr. Cash</b>	<b>Dr. Cash</b>



account within discount period	Dr. Sales discounts Cr. A/R	Dr. Sales discounts Cr. A/R
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## Income Statement Presentation

Two different forms of the income statement:

1. Single step income statement:
    - Data are classified into two categories:
      - Revenues
      - Expenses
  2. Multiple-step income statement:
    - Shows several steps in determining profit or loss:
      - a. Net sales
      - b. Gross profit
      - c. Profit from operations
      - d. Non-operating activities
      - e. profit
- Under IFRS, expenses should be classified either by nature or by function.
- By nature: salaries, transportation, depreciation, advertising.
  - By function: expenses are reported according to the activity for which they were incurred (cogs, administrative, selling).

## Single-step income statement

<b>Revenues</b>	
Net sales	\$460,000
Interest revenue	<u>3,400</u>
Total revenues	<u>463,400</u>
<b>Expenses</b>	
Cost of goods sold	316,000
Operating expenses	114,000
Interest expense	1,800



Loss on sale of equipment	200
Total expenses	<u>432,000</u>
Profit before income tax	31,600
Income tax expense	<u>6,300</u>
<b>Profit</b>	<b><u>\$ 25,300</u></b>

## Single-step income statement



Purchases - purchase returns and allowances - purchase discounts = net purchases + freight = Cost goods purchases

### An example of a sing step income statement-

#### EXERCISE 5-8

(a)

BLUE DOOR CORPORATION  
Income Statement (Single-Step)  
Year Ended December 31, 2015

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<i>Revenues</i>		
Sales.....	\$2,400,000	
Less: Sales returns and allowances.....	\$41,000	
Sales discounts.....	<u>8,500</u>	49,500
Net sales.....		<u>2,350,500</u>
Interest revenue .....	30,000	
Port revenue .....	24,000	\$2,404,500

of

Rent revenue .....	<u>24,000</u>	22,404,500
<i>Expenses</i>		
Cost of goods sold.....	\$1,085,000	
Salaries expense.....	675,000	
Depreciation expense.....	125,000	
Interest expense.....	70,000	
Advertising expense.....	55,000	
Freight out.....	25,000	
Insurance expense.....	<u>15,000</u>	<u>2,050,000</u>
Profit before income tax.....		354,500
Income tax expense.....		<u>70,000</u>
Profit.....		<u>\$ 284,500</u>

## Multiple-step income statement

Sales revenue

-cost of goods sold

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= gross profit

-operating expenses

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=profit from operations

+ (-) other revenues (expenses)

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=profit before income tax

-income tax expense

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=profit

### EXERCISE 5-8 (Continued)

(b)

BLUE DOOR CORPORATION  
Income Statement (Multiple-Step)  
Year Ended December 31, 2015

Sales .....		\$2,400,000
Less: Sales returns and allowances .....	\$41,000	
Sales discounts.....	<u>8,500</u>	<u>49,500</u>
Net sales.....		2,350,500
Cost of goods sold .....		<u>1,085,000</u>
Gross profit .....		1,265,500



<i>Operating expenses</i>		
Salaries expense .....	\$675,000	
Depreciation expense.....	125,000	
Advertising expense .....	55,000	
Freight out .....	25,000	
Insurance expense .....	<u>15,000</u>	
Total operating expenses.....		<u>895,000</u>
Profit from operations.....		<u>370,500</u>
<i>Other revenues and expenses</i>		
Interest revenue .....	\$30,000	
Rent revenue .....	24,000	
Interest expense .....	<u>(70,000)</u>	<u>(16,000)</u>
Profit before income tax.....		<u>354,500</u>
Income tax expense.....		<u>70,000</u>
Profit.....		<u>\$ 284,500</u>

## Evaluating Profitability

- Gross profit margin
  - Measures the gross profit expressed as percentage of net sales.

Gross profit margin =  $\frac{\text{Gross profit}}{\text{Net sales}}$

Net sales

- Profit margin
  - Measures the percentage of each dollar of sales that results in profit

Profit margin =  $\frac{\text{Profit}}{\text{Net sales}}$

(a)

(\$ in millions)	2012	2011
Gross profit margin	$\frac{\$11,427.2 - \$7,929.3}{\$11,427.2} = 30.6\%$	$\frac{\$10,387.1 - \$7,326.4}{\$10,387.1} = 29.5\%$
Profit margin	$\frac{\$499.2}{\$11,427.2} = 4.4\%$	$\frac{\$467.0}{\$10,387.1} = 4.5\%$



## comparing

# IFRS and ASPE

Key Differences	International Financial Reporting Standards (IFRS)	Accounting Standards for Private Enterprises (ASPE)
Income statement	Expenses must be classified by nature or by function.	Expenses can be classified by nature or by function, or by the company's internal organization.

**Standards for Private  
(ASPE)**

ified in any man-  
useful.