Chapter 5

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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 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 determined ending inventory

Records purchases of Merchandise

Purchases

1.

Perpetual	Periodic
Dr. Merchandise Inventory Cr. Cash or A/P	Dr. Purchases 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 cre
   - Purchase allowance:
     - The seller gives an allowance (deduction) from the purchase price
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Perpetual	Periodic
Dr. Cash or A/P Cr. Merchandise inventory	Dr. Cash or A/P Cr. Purchase returns and allow

dit

ances

Cr. Merchandise inventory	Cr. Purchase returns and allow

5. **Discounts**

- **Quanity 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 separeately when payment is made
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Perpetual	Periodic
Dr. A/P Cr. Cash Cr. Merchandise inventory	Dr. A/P Cr. Cash Cr. Purchase discounts

<u>SUMMARY.</u>

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

1.Sales

Perpetual	Periodic
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)	Dr. Cash or A/R Cr. Sales (to record the sale) 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 desintination point:
  - Freight changes are paid by the seller
  - The seller prepares the following entry
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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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Dr. Merchandise inventory Cr. Cost of goods sold (to record cost of goods returned)	No entry

5. **Discounts**

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

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

SUMMARY.

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

account within discount period	Dr. Sales discounts Cr. A/R	Dr. Sales discounts Cr. A/R

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

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

Loss on sale of equipment	200
Total expenses	432,000
Profit before income tax	31,600
Income tax expense	6,300
Profit	$ 25,300

Single-step income statement

Gross Sales − Sales Returns and Allowances − Sales Discounts = Net Sales

Beginning Inventory + Cost of Goods Purchased = Cost of Goods Available for Sale − Ending Inventory = Cost of Goods Sold

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

Revenues			
Sales		$2,400,000	
Less: Sales returns and allowances	$41,000		
Sales discounts	8,500	49,500	
Net sales		2,350,500	
Interest revenue		30,000	
Rent revenue		24,000	$2,404,500

of

Rent revenue	24,000	$2,404,500
Expenses		
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	15,000	2,050,000
Profit before income tax		354,500
Income tax expense		70,000
Profit		$ 284,500

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	8,500	49,500
Net sales		2,350,500
Cost of goods sold		1,085,000
Gross profit		1,265,500

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

Evaluating Profitability

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

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

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

Profit margin = Profit / 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 Standar Enterprises (
Income statement	Expenses must be classified by nature or by function.	Expenses can be classi ner the company finds

rds for Private (ASPE)
ified in any man- useful.