

Chapter 5- Merchandising Operations

Inventory System

- Companies that produce goods for sale are called manufacturers.
- A manufacturer has inventory classified into:
 - raw materials,
 - work in process,
 - finished goods.
- Two systems to account for inventory:
 - Perpetual
 - Periodic

Perpetual

- Detailed records of the cost of each inventory purchase 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.

Recording Purchases of Merchandise

1. Purchases

Perpetual	Periodic
Dr. Merchandise Inventory Cr. Cash or A/P	Dr. Purchases Cr. Cash or A/P

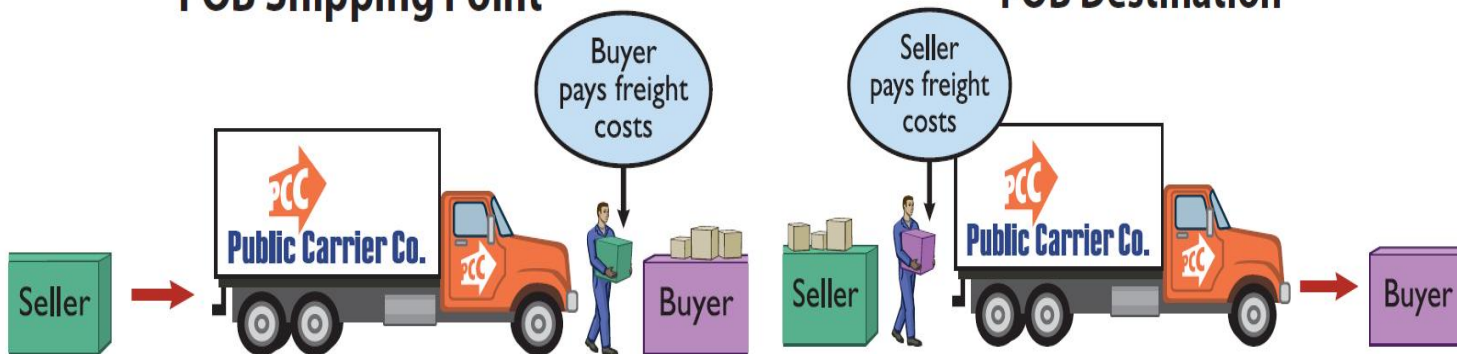
2. Sales taxes

- 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



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

- No journal entry for the seller

4. Purchase returns and allowances

- Purchase return:
 - The buyer returns the goods to the seller and receives a cash refund 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

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 balance due.
 - Example: 2/10, n/30.
 - recorded separately when payment is made.

Perpetual	Periodic
Dr. A/P Cr. Cash Cr. Merchandise inventory	Dr. A/P Cr. Cash Cr. Purchase discounts

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

Recording Sales of Merchandise

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 they are paid to the government.

3. Freight costs

If FOB destination:

- 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)
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

Perpetual	Periodic
Dr. Cash Dr. Sales discounts Cr. Accounts receivable	Dr. Cash Dr. Sales discounts Cr. Accounts receivable

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

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

Transaction	Perpetual	Periodic
Sale of merchandise	Dr. Cash or A/R Cr. Sales	Dr. Cash or A/R Cr. Sales
	Dr. Cost of goods sold Cr. Merchandise inventory	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. Sales returns and allowances Cr. Cash or A/R
	Dr. Merchandise inventory Cr. Cost of goods sold	No entry
Collection of account within discount period	Dr. Cash Dr. Sales discounts Cr. A/R	Dr. Cash 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:
 1. Net sales
 2. Gross profit (Total Sales—COGS)
 3. Profit from operations
 4. Non-operating activities
 5. 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	<u>3,400</u>
Total revenues	<u>463,400</u>
Expenses	
Cost of goods sold	316,000
Operating expenses	114,000
Interest expense	1,800
Loss on sale of equipment	<u>200</u>
Total expenses	<u>432,000</u>
Profit before income tax	31,600
Income tax expense	<u>6,300</u>
Profit	<u>\$ 25,300</u>

$$\text{Gross Sales} - \text{Sales Returns and Allowances} - \text{Sales Discounts} = \text{Net Sales}$$

$$\text{Beginning Inventory} + \text{Cost of Goods Purchased} = \text{Cost of Goods Available for Sale} - \text{Ending Inventory} = \text{Cost of Goods Sold}$$

$$\text{Purchases} - \text{Purchase Returns and Allowances} - \text{Purchase Discounts} = \text{Net Purchases} + \text{Freight (FOB shipping point)} = \text{Cost of Goods Purchased}$$

Multiple-step income statement

Sales revenue
 - Cost of goods sold
=Gross profit
 - Operating expenses
=Profit from operations
 +(-) other revenues (expenses)
=Profit before income tax
 - income tax expense
=Profit

Sales revenues		
Sales		\$480,000
Less: Sales returns and allowances	\$12,000	
Sales discounts	<u>8,000</u>	<u>20,000</u>
Net sales		460,000
Cost of goods sold		<u>316,000</u>
Gross profit		144,000
Operating expenses		
Salaries expense	\$45,000	
Rent expense	19,000	
Utilities expense	17,000	
Advertising expense	16,000	
Depreciation expense	8,000	
Freight out	9,000	
Loss on sale of equipment	<u>200</u>	
Total operating expenses		<u>114,200</u>
Profit from operations		29,800

Profit from operations (continued)		\$ 29,800
Other revenues and gains		
Interest revenue	\$3,400	
Other expenses and losses		
Interest expense	<u>1,600</u>	<u>1,800</u>
Profit before income tax		31,600
Income tax expense		<u>6,300</u>
Profit		<u>\$ 25,300</u>

Evaluating Profitability

1. Gross Profit Margin

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

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 = $\frac{\text{Profit}}{\text{Net Sales}}$

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 in any manner the company finds useful.

Single Step Income Statement

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Revenue

Net Sales: 2, 350,500 (Sales — sales returns and allowances)

Interest revenue

Rent revenue

Total Revenue: 2,404,500

Expense

COGS

salaries

Intrest

Dep

Ad

Freight Out

Insurance

Total Expenses 2,050,000

Profit b4 income tax 354,500

Income tax expense 70,000

Total Profit 284,500

February 5, 2018

Multiple Step Income Statement

Revenue

Net Sales 2,350,500

Cogs

Gross profit

Expense

Total Profit