UNIT 3
ACCOUNTING FOR MERCHANDISING BUSINESSES

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NATURE OF A MERCHANDISING BUSINESS

1. **What is a Merchandising Business**?

- A merchandising business buys goods in finished form for resale to customers.
- A merchandising business sells tangible goods to its customers. When we say goods it can be anything that has physical characteristics that you can see and touch (i.e., tangible).

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- These can be goods ranging from television sets, cars, office table and chair (furniture), to chewing gums, toothbrushes and various stationery.
- These goods that a merchandising company sells to its customers are called ***merchandise inventory***.
- A customer is an individual or a firm to whom a business sells its products.

Contd…

- A **wholesaler** is a trader, which buys goods from manufacturers and sells them to a retailer or another wholesaler.
- It is the **retailer** who sells the goods to the final consumer by buying them from wholesalers (or sometimes from a manufacturer).

Comparison of Financial Statements for Merchandising and Service Businesses

- ***Income Statement***

A model income statement for a merchandising business and another one for a service business are shown below. Compare them carefully.

Contd…

ABC service company Income statement For the year ended Dec.31, 200x	XYZ merchandising Income statement For the year ended Dec.31, 200x
Revenue: Service fee……Birr 23,200	Revenue: Net Sales……Birr 360,000 Cost of goods sold……. (256,000) Gross Profit ……104,000
Expenses: Various Operating Expenses	Various Operating Expenses……

Contd…

- ***Balance Sheet***

The Balance Sheet of a service business and that of a merchandising business are similar in every aspect except one thing.

The current assets section of the Balance Sheet of a merchandising business includes one asset that service companies do not have. **That is merchandise inventory.**

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- Merchandise inventory refers to goods bought by a merchandising business for resale to customers.
- So, if a merchandising business has some unsold goods (merchandise) on hand at the end of the year this would be reported as one asset on the Balance Sheet

THE PERIODIC AND THE PERPETUAL INVENTORY SYSTEMS

- The value of goods (merchandise) on hand at the end of the year for resale would be reported on the Balance Sheet as one asset as described above. This means that we need to open a separate ledger account in which to record merchandise inventory information.

The two alternatives in dealing with this account are:

- To up date this account every time goods are bought and sold (continuously = perpetually) or
- To up date this account only at the end of the period (periodically).

The Periodic Inventory System

- Under this system, as the name periodic suggests, the inventory account is updated only periodically i.e., only at the end of a period.
- When goods are bought, a temporary ***purchases* account is debited instead of the inventory account** itself.
- Likewise, **when goods are sold revenue is recorded**, but the fact that there is a reduction in merchandise inventory is not recognized. **This is because the Merchandise Inventory account is not credited every time goods are sold.**

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- *In conclusion,* ***under the periodic system, since the merchandise inventory account is not continually updated, the cost of merchandise on hand is determined only at the end of the period after carrying out a physical inventory.***
- Companies such as department stores or ‘super markets’, which sell small items, use periodic systems.

Perpetual Inventory Systems

- **A perpetual inventory system continuously records the amount of inventory on hand (perpetual =continuous). Under this system, the merchandise inventory account is debited or credited every time (goods) are bought or sold.**
- **When an item is sold, its cost is recorded in a separate cost of goods sold account in addition to recording sales.**
- The cost of merchandise on hand can be looked up from the merchandise Inventory account any time, without conducting a physical inventory.

Recording Sales

- When a merchandising company transfers goods to the buyer, in exchange for cash or a promise to pay at a later date, revenue is produced to the company. This revenue is recorded in a **Sales** account.
- However, the sales revenue, which is reported on the Income Statement is **Net Sales**. That is,
- **Net Sales = Gross Sales – Sales Discounts- Sales Returns and Allowances**

Recording Gross Sales

- The gross sales amount is obtained from sales invoices. An **invoice** is a document, prepared by the seller of merchandise to notify to the buyer the details of the sale.
- These details can include number of items sold, unit price of items, total price, terms of sale and manner of shipment. When goods are delivered to the customer, the Sales account is credited because revenues are increased by credits.
- A company can sell goods either for cash or on account.

Recording Cash Sales

- When merchandise is sold on cash, the Cash account is debited and the revenue account Sales is credited.

Example – Ika Company based in Bahir Dar, buys and sells used commodities. On January 14. 2001. Ika sold goods for Birr 20,000. Record the transaction.

Answer:

January 14, DEBIT CREDIT

Cash.....20,000.00

Sales.....20,000.00

Recording Credit Sales

- The Accounts Receivable account is debited when goods are sold on account (for credit).

Example

Ika sold goods worth Birr 35,000 on account on January 15, 2001. Record the transaction.

Solution

January 15.	DR	CR
Accounts Receivable.....	35,000.00	
Sales.....		35,000.00

Determining Gross Sales when there are trade discounts

A trade discount is a percentage deduction from the specified list price or catalogue price of merchandise.

Trade discounts allow us:

- To avoid publishing a new catalogues every time prices change.
- To grant quantity discounts
- Quotation of different prices to different types of customers.
- Trade discounts are not recorded in the seller's accounting records; they are only used to calculate the gross selling price.

Contd…

Example: IKA sold 500 T.V. sets, each with a list price of Birr 80, on January 17, 2001 for cash. It gave the customer a 30% trade discount, as the customer was a very loyal one. Record the sale.

Answer:

List price of goods (80 X 500) Birr 40,000

Less: Trade discount (30 % of 40,000) (12,000)

Invoice price 28,000

Journal entry:

Cash……28,000

Sale……28,000

Contd…

Recording Deductions from Gross Sales

Go back to illustration 1- and have a look at the model Income Statement of a merchandising company.

You will see that the sales reported on the income statement is net sales, i.e., after deduction of sales discounts and sales returns and allowances.

Contd…

Gross sales (from invoice)…….. XXX

Less: Sales discounts……..(XX)

Sales returns and allowances …… (XX)

Net sales…….. XX

Sales Discounts

- Sales Discounts are deductions from invoice price to customers who pay early when goods are sold on credit.
- As a seller, you would usually want to be paid as soon as possible. This is because, as you can imagine, you can use the money for various purposes once you have been paid.
- If you want your customers to pay you early the customary practice is to offer them a (deduction) discount from the invoice price if they pay early.

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- How much discount is given usually depends on the **credit ter**ms. These terms (agreements) are usually stated on the invoice. The most frequently used terms are stated below:
- “n/30” or “Net 30” – means there is no discount even if the customer pays before the payment date.
- 2/10, n/30 –means the due date of the payment is after 30 days of the sale. But if the customer pays with in 10 days she will get a 2% discount.
- 2/EOM, n/60- means the normal due date is within 60 days of the sale but the customer will get a 2% discount if she pays before the end of month of sale.

Sales Returns and Allowances

- Customers can return merchandise they have bought if they find it to be defective or of the wrong model, or unsatisfactory for a variety of reasons.
- A sales return is merchandise returned by a buyer. The buyer would be paid back her money if she has already paid.

A ***sales allowance***

- A ***sales allowance*** is a deduction from the original invoice price when the customer keeps the merchandise but is dissatisfied.
- If for example, a customer buys an item worth birr 100 and finds it to be of the wrong color after receiving it, she may still want to retain the item even if she is dissatisfied with its color.
- In that case the seller may let her pay only, say, Birr 95 by giving her an allowance of Birr 5.

Contd…

Example:

- IKA Company sold merchandise worth Birr 15, 000 on February 3, 2001 on account terms 2/10, n/30. On February 5, the buyer returned a portion of the goods worth Birr 5,000 as they were found to be of the wrong model. The buyer then paid on February 13, 2001.
- Record the necessary journal entries on February 3,5 and 13.

Solution:

February 3 A/R.....15,000
Sales 15,000

February 5 Sales Returns and Allowances5,000
A/R.....5,000

February 13 Cash.....9800
Sales Discount 200
A/R.....10,000

Contd….

- Here, the buyer paid with in the discount period. Therefore, the amount that would be collected is:

15,000 – 5,000 = 10,000

Deduct: 2% Cash discount (200)

Cash collected 9800

Recording Purchases

- Under the periodic inventory system a merchandising company uses the Purchases account to record the cost of goods **bought** for resale to customers.

Example:

IKA Company bought goods worth Birr 43,000 from Saba Co., which is based in Addis Ababa, on account on January 4, 2001, terms 20/10, n/30. Record the transaction.

Solution:

January 4 – Purchases 43,000

Accounts payable.....43,000

Purchase Discounts

- A merchandising company can buy goods under credit terms that permit it to get a discount if it pays with in a specified period of time.
- The deduction from the original purchase price is recorded in a separate contra Purchase account called Purchase Discounts.

Contd…

Example:

IKA Company bought goods worth Birr 50,000 from Gibir Company on account on January 14, 2001, terms 1/10,n/60. Ika Company paid on January 24, 2001. Record the transactions on both dates.

Contd…

Solution:

Jan. 14. Purchases……50,000

A/P……. 50,000

Jan. 24. A/P……. …50,000

Purchase Discounts 500

Cash……. 49,500

Purchase Returns and allowances

- A purchase return occurs when a buyer returns merchandise to a seller.
- A purchase allowance is a reduction on the price of goods bought for dissatisfaction on the side of the buyer.
- Both purchase returns and purchase allowances are recorded in a contra purchase account called Purchase Returns and Allowances.

Contd…

Example:

- In the previous example for IKA Company, a portion of the goods worth birr 5,000 bought on January 14 from Gibir Company were of the wrong size. Gibir Company acknowledged this and gave IKa Company a 5% price allowance on January 17.
- What should IKA Company record on January 17?

Contd…

Solution:

January 17 A/P……250

Purchase Returnes and Allowance……250

Transportation costs

- Once merchandise has been bought it has to be moved from the seller’s place to the buyer’s place.
- A third party comes in to the scene here: the **transportation company** who moves the goods between the two places.

Contd…

- So, the question is, who is going to pay to the freighter (transportation) company. Who covers the transportation costs depends, as you might have guessed, on the agreement between the buyer and seller.
- The agreements are usually stated in the either of these two terms:

1. FOB Destination
2. FOB Shipping point

1. ***FOB Destination***

- ***FOB Destination*** – means “free on board at destination “. That is, since the destination of the goods is the buyer’s place, it is free at destination means transportation cost is paid when the goods are loaded.
- It simply means the seller pays transportation cost.
- FOB Destination means goods are shipped to their destination (to the buyer) with out transportation charge to the

2. FOB shipping Point

- ***FOB shipping Point –***means " free on board at shipping point". That is, goods are loaded (on a truck or train) or shipped free of charge. It is, therefore, the buyer, which pays to the transportation company when the goods reach the buyer (their destination)
- Briefly, when the terms are <u>FOB Shipping Point the buyer pays transportation costs.</u>

Contd…

- Transportation costs paid by a buyer of merchandise increase the cost of merchandise.
- They are recorded in a separate Transportation-In account that is used to record freight costs incurred in the acquisition of merchandise.

Contd…

Example

- IKA Company bought goods worth Birr 85,000 on account, terms 2/10,n/60 FOB shipping point on March 2, 2001.Transportoin cost of Birr 1,500 was paid on March 2. Ika Company paid on March 31, 2001. Record the necessary journal entries

Solution:

Here, since the terms are FOB Shipping Point, the buyer (Ika) pays transportation.

- March 2 -Purchase……85,000
  A/P……85,000
  -Transportation In……1500
  Cash……1500
- March 31 A/P……85,000
  Cash……85,000

Contd…

Example:

- IKA Company sold goods worth Birr 135,000 terms 1/15, n/EOM on February 1, 2001. FOB Destination. It also paid transportation costs of Birr 800 on Feb. 1. The customer paid IKA on February 16, 2001. Record the relevant Journal entries.

Contd….

Answers:

- Feb 1 A/R……135,000
  Sales……135,000
- Feb 16 Sales discount ……1,350
  Cash……133,650
  A/R……135,000
  Delivery Expense……800
  Cash……800
- The ***Delivery Expense*** account shows how much was incurred to deliver goods sold to customers. It is, therefore, shown on the income statement as a selling expense.

Example

- Raey Co. sold goods worth Birr 40,000 on April 1, 2001 to IKA company terms 2/10, n/30 FOB Shipping Point. It also paid Birr 2,500 to Ergib Movers for transporting the goods and added the amount to the invoice. What would each of these companies record assuming IKA paid on April 31, 2001

Solution

Raey Co. (seller)	IKa Co (Buyer)
April 1- A/R.....40,000	April 1-Purchases 40,000
Sales..... 40,000	A/P.....40,000
A/R.....2500	Transport-in 2500
Cash.....2500	A/P..... 2500
April 31-Cash.....42,500	April 31- A/P.....42,500
A/R..... 42500	Cash..... 42,500

Contd….

Example:

- X Company bought merchandise worth Birr 14,000 terms FOB destination from Y Co. on account. It paid Birr 350 transportation costs. What would be recorded on the books of the buyer and seller on the date of the sale?
- **Buyer (X Co)** **Seller Y Co.**

Purchase……14,000 A/R……14,000

A/P……14,000

Sales……14,000

A/P……350 Delivery exp……350

Cash……350 A/R……350

REPORTING MERCHANDISING TRANSACTIONS

COMPLETING THE WORKSHEET FOR A MERCHANDISING COMPANY

- The use of a worksheet, as you remember, assists in preparing adjusting and closing entries. In addition it contains all of the information needed for the preparation of the financial statements. Except for the merchandise – related accounts, the work sheet for a merchandising Co. is the same as for a service company.
- The following illustration, therefore, assumes that all selling and administrative expenses have been adjusted. That accomplished, the only account, which remains to be adjusted, is the Merchandise Inventory account.

Illustration

- The following is the trial balance of Hard Works, a merchandising business owned by Yibeltal. All accounts have been adjusted except the Merchandise Inventory account.

Hard Works
Trial Balance
December 31, 2002

Account title	**Dr**	**CR**
Cash	19,663	
Account Receivable	1,880	
Merchandise Inventory	7,000	
Accounts Payable		700
Yibeltal, Capital		25,000
Yibeltal,Drawings	2,000	
Sales		14,600
Sales Discounts	44	
Sales Returns and Allowances	20	
Purchases	6,000	
Purchase discounts		82
Purchase Returns and allowances		100
Transportation –In	75	
Selling expenses	2,650	
Administrative expenses	1,150	
	40,482	40,482

Contd…

- A physical inventory of merchandise carried out on December 31, 2002 showed Birr 10,000 of goods on hand.
- ***Required:***

A- Prepare a worksheet for Hard Works.

B- Prepare financial statements from the worksheet

C- Record the necessary adjustment journal entry in relation to merchandise inventory

D- Record closing entries

Hard Works Co.
Worksheet for the year ended December 31,2002

Account title	Trial Balance		Adjustment		Adjusted Trial balance		Income statement		Balance sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	19,663				19,663				19,663	
Account Receivable	1,880				1,880				1,880	
Merchandise Inventory	7,000		10,000	7,000	10,000				10,000	
Accounts Payable		700				700				700
Yibeltal, Capital		25,000				25,000				2,5000
Yibeltal, Drawings	2,000				2,000				2,000	
Income summery			7,000	10,000	7,000	10,000	7,000	10000		
Sales		14,600				14,600		14600		
Sales Discounts	44				44		44			
Sales Returns and Allowances	20				20		20			
Purchases	6,000				6,000		6,000			
Purchase discounts		82				82		82		
Purchase Returns and allowances		100				100		100		
Transportation –In	75				75		75			
Selling expenses	2,650				2,650		2,650			
Administrative expenses	1,150				1,150		1,150			
	40,482	40,482	17,000	17,000	50,482	50,482	16,939	24782	33,543	25,700
Net income							7,843			78,43
							24,782	24782	33,543	33,543

Note:

- The merchandise inventory account before adjustment shows the inventory on hand at the beginning of the period. This is because, since purchases and sales of merchandise have not been debited or credited to the merchandise inventory account, this account would still show the beginning inventory amount at the end of the period.
- Therefore, an adjustment journal entry is needed to update this account. At the end of the period, a physical inventory would be conducted to determine the amount of inventory on hand.
- The adjustment journal entry removes beginning inventory amount from the merchandise inventory account and replaces it with the (ending) actual value of merchandise inventory on hand as determined by the physical inventory.

- ***The adjustment is:***

Income summary (beginning inventory)…… XXX

Merchandise amount inventory……XXX

Merchandise Inventory……XXX

Income Summary……XXX

- An adjustment journal entry for Hard Works is presented latter in (c).

PREPARING FINANCIAL STATEMENTS FOR MERCHANDISING BUSINESSES

1. Income Statement

There are two widely used formats of the income statement. These are:

The single – Step Income Statement

This format is shown below for Hard Works Co. It shows cost of goods sold and operating expense but has only one subtotal for total expenses.

Hard Works Co.

Income statement

For the year ended December 31, 2002

Net sales.....Br.14536

Expenses:

- Cost of goods sold.....2893
- Operating Expenses 3800 (6693)

Net Income.....7843

-

XYZ Merchandising Co.
Income statement
For the year ended Dec. 31,2001

Gross Sales 400,000
Less: Sales Discounts (15,000)
Sales Ret &All (25,000)..... ..... (40,000)
Net sales..... 360,000

Cost of goods sold:
Beginning merchandise inventory (January 1, 2001)... 10,000
Add: Purchases.....210,000
Less: Purchase Disc.....(5,000)
Purchase Ret & All...(5,000)
Net purchase.....200,000
Add: Transportation –In..... 66,000
Total cost of goods Available for sale..... 276,000
Less: Ending M.I (Dec. 31,2001)..... (20.000)
Cost of goods sold..... ..... (256,000)
Gross profit..... 104,000
Less: Various Selling and Administrative Expenses .....(79,400)
Net Income..... 24,600

2. Statement of Owner's Equity

Hard Works Co.
Statement of Owner's Equity
For the year Ended December 31, 2002

Yibeltal Capital Jan1,2002……Br..25,000
Add: Net Income for the year…… 7843
Net increase in capital…… 32,843
Deduct:Owner's withdrawal during the year…(2,000)
Yibeltal Capital December 31, 2002……30843

3. **Balance sheet**

Hard Works Co.

Balance sheet

For the year Ended December 31, 2002

Assets: Liabilities & capital

Liabilities:

Cash……19663 A/P……700

A/R…… 1880 Owner's Equity:

Merch. Inventory…….10,000 Yibeltal Capital … 30843

- Total Assets……31,843 Total Liab. & O/E…… 31,843

Note:

- Under a periodic inventory system, the cost of goods sold during a period is determined only indirectly after comparing what was on hand at the beginning of the period, and
- the cost of goods purchased during the period with what is left on hand at the end of the period. That is, Beg inventory + Total cost of purchase –Ending inventory=Cost of Goods Sold.

Contd…

- Under periodic inventory procedures no attempt is made to determine the cost of goods sold at the time of each sale. Instead, the cost of all the goods sold during the accounting period is determined at the end of the period.

Summary of Important Relationships on the Income Statement

- Net sales = Gross sales- (Sales Discounts + Sales Returns and allowances)
- Net purchases = Purchases – (Purchase Disc. + Purchase Ret. & allowance)
- Total cost of Purchase = Net purchase + Transportation –In
- Cost of goods Available for sale= Beg inventory + Total cost of purchase
- Cost of goods sold = Cost of goods Available for sale–Ending inventory
- Gross profit = Net sales – Cost of goods sold
- Net Income = Gross Profit – operating Expenses (i.e., selling & administrative) expenses.

A. Adjustment Journal entry

1. Adjusting merchandise beginning inventory

Income summary.....7,000

Merchandise Inventory.....7,000

2. Adjusting ending merchandise inventory

Merchandise Inventory.....10,000

Income Summary.....10,000

B. Closing entries

1. Closing of revenue (Sale) and other accounts which has credit balance into debit using income summery account

Sales……14,600

Income summary……14,600

Purchase Discounts……82

Purchase Ret. &All……100

- Income Summary……182

.2. Closing of those accounts which has debit balance into credit using income summery account

Income summary……66

Sales discount……44

Sales Returns and Allowances…… 20

Contnd…

-Income summary……6,075

Purchases……6,000

Transportation-In……75

Income summary……3,800

Selling Expenses……2650

Administrative expense……1150

3. Closing of income summery account which has credit balance into capital account

Income summary……7,843

Yibeltal Capital……7,843

4. Closing of drawing account which has debit balance into capital account

Yibeltal Captal……2,000

Yibeltal Drawings……2,000

END OF CHAPTER THREE !!!