CHAPTER THREE

ACCOUNTING FOR MERCHANDISE BUSINESSES

3.1 Characteristics of Merchandising Business:

The activities of a service business differ from those of a merchandising business. The revenue activities of a service business involve providing services to customers. On the income statement for a service business, the revenues from services are reported as fees earned. The operating expenses incurred in providing the services are subtracted from the fees earned to arrive at net income.

In contrast, the revenue activities of a merchandising business involve the buying and selling of merchandise. A merchandising business first purchases merchandise to sell to its customers. When this merchandise is sold, the revenue is reported as sales, and its cost is recognized as an expense. This expense is called the cost of merchandise sold. The cost of merchandise sold is subtracted from sales to arrive at gross profit. This amount is called gross profit because it is the profit before deducting operating expenses. Merchandise on hand (not sold) at the end of an accounting period is called merchandise inventory. Merchandise inventory is reported as a current asset on the balance sheet.

Merchandise consists of products, also called goods that a company acquires to resell to customers**. A merchandiser** earns net income by buying and selling merchandise. Merchandisers are often identified as either wholesalers or retailers. **A wholesaler** is an intermediary that buys products from manufacturers or other wholesalers and sells them to retailers or other wholesalers. **A retailer** is an intermediary that buys products from manufacturers or wholesalers and sells them to consumers. Many retailers sell both products and services.

3.1.1 Comparison of Financial Statements for Merchandising and Service Businesses

Service Business	Merchandising Business
Revenues - Expenses = Net Income or Net Loss	Net Sales - CGS= Gross Profit - Expenses = Net Income/Net Loss

3.1.2 Inventory Systems;

Two alternative inventory accounting systems can be used to collect information about cost of goods sold and cost of inventory; (the **perpetual system** or **periodic system).**

- Under the **periodic inventory system,** the inventory records do not show the amount available for sale or the amount sold during the period. The periodic inventory system updates the accounting records for merchandise transactions only at the end of a period. Under this system; Purchases of merchandise are debited to Purchases; Ending Inventory determined by physical count; At the time of sale no need of recording CGS and Calculation of Cost of Goods Sold is;

	Beginning Inventory	xx
Add	Net Cost of Purchases	xx
	Merchandise Available for Sale	xxx
Less	Ending Inventory	(xx)
	Cost of Goods sold	**xxx**

- Under the **perpetual inventory system** of accounting, each purchase and sale of merchandise is recorded in the inventory and the cost of merchandise sold accounts. As a result, the amounts of merchandise available for sale and sold are continuously (perpetually) updated in the inventory records. The perpetual inventory system continually updates accounting records for merchandising transactions – specifically, for those records of inventory available for sale and inventory sold. Under this system; there is continuous record of inventory and

cost of goods sold to disclose the amount of the inventory; purchases of merchandise and freight-in should be debited to inventory; purchase returns and allowances and purchase discounts are credited to inventory; cost of goods sold is debited and inventory is credited for each sale; subsidiary records show quantity and cost of each type of inventory on hand; the cost of merchandise sold will be recorded each time a sale is made and physical inventory is taken to compare the records with the actual quantities on hand.

- **Cost of goods sold** is the cost of merchandise sold to customers during a period.
- **Inventory** refers to products a company owns and expects to sell in its normal operations.
- Merchandise available for sale consists of what it begins with (beginning inventory) and what it purchases (net cost of purchases).
- The merchandise available is either sold (cost of goods sold) or kept for future sales (ending inventory).

3.2 Accounting for Merchandise Purchases:

3.2.1) Accounting for Merchandise Purchases Under Periodic System:

A **periodic inventory system** requires updating the inventory account only at the end of a period to reflect the quantity and cost of both the goods available and the goods sold. Thus, during the period, the merchandise inventory balance remains unchanged. It reflects the beginning inventory balance until it is updated at the end of the period. During the period the cost of merchandise is recorded in a temporary **purchase account.** When a company sells merchandise, it records revenue but not the cost of the goods sold. At the end of the period when a company prepares financial statements, it takes a physical count of inventory by counting the quantities and costs of merchandise available. The cost of goods sold is then computed by subtracting the ending inventory amount from the cost of merchandise available for sale.

Under a periodic system, each purchase, purchase return and allowance, purchase discount, and transportation-in transaction is recorded in a separate temporary account. At period-end, each of these temporary accounts is closed and the merchandise account is updated.

Example -1: Assume **ABC Company** purchased merchandise inventory Birr 10,000 from **Yahoo Compan y** on December-1, 2008 for cash and Birr 100,000 from **Yahoo Company** on December-2, 2008, term 2/10, n/30. The entry will be;

Date	Explanation	Debit	Credit
December-1, 2008	Purchase	10,000	
	Cash		10,000
	(Purchased merchandise on cash) 60)		
December-2, 2008	Purchase	100,000	
	Accounts Payable - Marathon Company		100,000
	(Purchased merchandise, terms 2/10, n/30)		

Example -2: Assume **Hanlon Retail** purchased Birr 30,000 of merchandise on credit on **May-4, 2005** terms 2/15, n/60 and on **May-21, 2005** purchased Birr 20,000 of merchandise for cash from **Marathon Company**. The entry will be;

Date	Explanation	Debit	Credit
May-4, 2005	Purchase	30,000	
	Accounts Payable - Marathon Company		30,000
	(Purchased merchandise, terms 2/10, n/60)		
May-21, 2005	Purchase	20,000	
	Cash		20,000
	(Purchased merchandise on cash)		

Example -3: Assume **ABC Company** bought goods worth Birr 50,000 from **XYZ Company** on account on January-14, 2001, terms 1/10, n/60. Assume that ABC Company, a portion of the goods worth Birr 5,000 bought on January-14 from XYZ Company was of the wrong size. XYZ Company acknowledged this and gave ABC Company a **5% price** allowance on January-17. ABC Company paid on January-24, 2001. Record the transactions on both dates.

Date	Explanation	Debit	Credit
January-14, 2001	Purchase	50,000	
	A/P – XYZ Company		50,000
	(Record Purchase On credit)		
January-17, 2001	**A/P – (5%*5,000)**	250	
	Purchase return & Allowance		250
	(Record Purchase return & Allowance)		
January-24, 2001	Accounts Payable – XYZ Company	49,750	
	Cash		49,252.5
	Purchase discount		497.5
	(Record Purchase on Credit -1/10, n/60 term with in discount)		

Example -4: Assume **Delina Company** purchased merchandise inventory Birr 500,000 from **Axumite Company** on January-1, 2006 term 1/10, n/30. Axumite Company returned defective items of Birr 10,000 to Delina Company on January-3, 2006. Delina Company made price allowance of Birr 3,000 for those additional defective items of Birr 5,000 to Axumite Company of January-5, 2006 and if Axumite Company paid the remaining amount on January-11 and 12, 2006;

Date	Explanation	Debit	Credit
January-1, 2006;	Purchase	500,000	
	A/P – Axumite Company		500,000
	(Record Purchase On credit)		
January-3, 2006;	A/P	10,000	
	Purchase return & Allowance		10,000
	(Record Purchase return & Allowance)		
January-5, 2006;	A/P	3,000	
	Purchase return & Allowance		3,000
	(Record Purchase return & Allowance)		
January-11, 2006;	Accounts Payable – Axumite Company	487,000	
	Cash		482,130
	Purchase discount		4,870
	(Record Purchase on Credit -1/10, n/60 term with in discount)		
January-12, 2006;	Accounts Payable – Axumite Company	487,000	
	Cash		487,000
	(Record Purchase on Credit -1/10, n/60 term out of discount)		

3.2.2) Accounting for Merchandise Purchases Under Perpetual System:

Under Perpetual Method, each purchase and sale of merchandise is recorded in the inventory and the cost of merchandise sold accounts. The amount of merchandise available for sale and the amount sold are continuously disclosed in the inventory records. The cost of merchandise purchased for resale is recorded in the Merchandise Inventory asset account.

Example -5: Assume on January-3, 2011; **Net Solutions** purchased merchandise for cash from **Bowen Company** Birr 2,510. The journal entry will be;

Date	Explanation	Debit	Credit
January-3, 2011	Merchandise Inventory	2,510	
	Cash		2,510
	(Purchase of Merchandise Inventory for Cash)		

Note: the amount recorded for merchandise inventory includes its purchase cost, shipping fees, taxes, and any other costs necessary to make it ready for sale.

☑ **Purchase Discount:** The purchase of goods on credit requires a clear statement of expected future payments and dates to avoid misunderstandings. The arrangement agreed upon by the **buyer** and **seller** as to when payments are to be made are called **Credit terms.** Credit terms for a purchase include the amounts and timing of payments from a buyer to a seller. Many businesses frequently grant a cash discount to customers who will pay promptly for goods purchased on credit.

For Example; when sellers require payment within **10 days** after the end of the month of the invoice date, the invoice will show credit terms of "n/10 EOM," which stands for net 10 days after end of month (EOM). When sellers require payment within 30 days after the invoice date, the invoice shows credit terms of "n/30," which stands for net 30 days. The amount of time allowed before full payment is due is called the **credit period.** Sellers can grant a **cash discount** to encourage buyers to pay earlier. A buyer views a cash discount as **a purchase discount.** A seller views a cash discount as a **sales discount.** Any cash discounts are described in the credit terms on the invoice. **For Example;** credit terms of "2/10, n/60" mean that full payment is due within a 60-day credit period, but the buyer can deduct 2% of the invoice amount if payment is made within 10 days of the invoice date. This reduced payment applies only for the **discount period.**

Example -6: Assume on March-12, 2011; **Alpha Technologies** issues an invoice for Birr 3,000 to **Net Solutions** dated with terms **2/10, n/30.** What are the last day the invoice can be paid and the entry to record the purchase? What is the journal entry for the purchase on March-12 and for the payment if on March-22 or April-11?

Invoice period	30	**The full amount is due on April-11.**
Days in March	31	
Date of invoice	12	
Remaining days	19	
April	**11**	

Date	Explanation	Debit	Credit
March-12, 2011	Merchandise Inventory	3,000	
	Accounts Payable – Alpha Technologies		3,000
	(Purchased merchandise on credit, invoice dated Mar. 12, terms 2/10, n/30)		
March-22, 2011	Accounts Payable – Alpha Technologies	3,000	
	Cash		2,940
	Merchandise Inventory		40
	(Paid for the Birr 3,000 purchase of Mar-12 less the discount of 2%)		
April-11, 2011	Accounts Payable – Alpha Technologies	3,000	
	Cash		3,000
	(Paid the full amount Birr 3,000 for the purchase of Mar. 12)		

☑ **Purchases Returns and Allowances:** A buyer may return merchandise (purchases return) or request a price allowance (purchases allowance) from the seller. In both cases, the buyer normally sends the seller **a debit memorandum**. A debit memorandum, often called a debit memo. A debit memo informs the seller of the amount the buyer proposes to debit to the account payable due the seller. It also states the reasons for the return or the request for the price allowance. The buyer may use the debit memo as the basis for recording the return or allowance or wait for approval from the seller (creditor). In either case, the buyer debits Accounts Payable and credits Merchandise Inventory.

☞ **Purchase return:** Refers to merchandise a buyer acquires but then returns to the seller. A **purchases return** involves actually returning merchandise that is damaged or does not meet the specifications of the order.

☞ **Purchase allowance:** Refers to a reduction in the cost of defective or unacceptable merchandise that a buyer acquires. When the defective or incorrect merchandise is kept by the buyer and the vendor makes a price adjustment, this is a **purchases allowance.** When a buyer returns or takes an allowance on merchandise, the buyer issues a **debit memorandum** to inform the seller of a debit made to the seller's account in the buyer's record.

Example -7: Assume on March-7, 2011; **Net Solutions** received the delivery from **Maxim Systems** and determined that Birr 900 of the items was not the merchandise ordered. **Debit memorandum** #18 is issued to Maxim Systems.

Date	Explanation	Debit	Credit
March-7	Accounts Payable - Maxim Systems	900	
	Merchandise Inventory		900
	(Debit Memo No.18 –Purchase Return)		

Example -8: Assume on May-2, 2011; **Net Solutions** purchased Birr 5,000 of merchandise from **Delta Data Link**, subject to terms 2/10, n/30. On May-4, 2011 Net Solutions returns Birr 3,000 of the merchandise. On May-12, Net Solutions pays the amount due. The entry to record this;

Date	Explanation	Debit	Credit
May-2, 2011	Merchandise Inventory	5,000	
	Accounts Payable – Delta Data		5,000
	(Purchased merchandise on credit, invoice dated May-2, terms 2/10, n/30)		
May-4, 2011	Accounts Payable – Delta Data	3,000	
	Merchandise Inventory		3,000
	(Returned portion of Merchandise Purchased)		
May-12, 2011	Accounts Payable – Alpha Technologies	2,000	
	Cash		1,960
	Merchandise Inventory		40
	(Paid invoice; (5,000 – 3,000) x 2%)		

Note: When goods are returned, a buyer can take a purchase discount on only the remaining balance of the invoice.

3.2.3) Comparison of Periodic and Perpetual Inventory System: Examples;

☑ **Purchases:** The periodic system uses a temporary purchase account that accumulates the cost of all purchase transactions during each period.

Example -9: Assume on Feburaury-1, 2011**; Net Solutions** purchased merchandise for Birr 1,200 on credit with terms of 2/10, n/30 is recorded as follows:

	Periodic Inventory System			Perpetual Inventory System		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
Feburaury-1, 2011	Purchases	1,200		Merchandise Inventory	1,200	
	Accounts Payable		1,200	Accounts Payable		1,200
	(To Record Purchase of Inventory on Credit)			**(To Record Purchase of Inventory on Credit)**		

☑ **Purchase Discounts:** The periodic system uses a temporary purchase discounts account that accumulates discounts taken on purchase transactions during the period. If payment is delayed until the discount period expires, full amount should be paid and the entry is to debit Accounts Payable and credit cash for Birr 1,200 each.

Example -10: Assume on Feburaury-10, 2011 **Net Solutions** pays the supplier for the previous purchase in Feburaury-1, 2011.

	Periodic Inventory System			Perpetual Inventory System		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
Febura ury-10, 2011	Accounts Payable	1,200		Accounts Payable	1,200	
	Purchase Discount		24	Merchandise Inventory		24
	Cash		1,176	Cash		1,176
	(Record payments -1,200*98% =1,176)			**(Record payments -1,200*98% =1,176)**		

☑ **Purchase Returns and Allowances:** Net Solutions returned merchandise purchased on November 2 because of defects. In the periodic system, the temporary purchase returns and allowances account accumulates the cost of all returns and allowance during a period.

☑ **Transportation-in:** FOB shipping point agreement implies to be covered the transportation/freight costs by the buyer and FOB destination implies to be covered the transportation/delivery costs by the seller.

Example -11: Assume Feburaury-13, 2011 **Net Solution** purchase Merchandise Inventory Birr 16,000 from **Magna Delta** Company term of 1/10, n/60 FOB shipping point. Feburaury-14, 2011 Net Solution returns Merchandise Inventory Birr 3,000 which was defective merchandise from Merchandise Inventory of Birr 16,000 and paid transportation Birr 75. The entry to record returns will be;

	Periodic Inventory System			Perpetual Inventory System		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
Feburaury-14, 2011	Accounts Payable	3,000		Accounts Payable	3,000	
	Purchase Returns and Allowance		3,000	Merchandise Inventory		3,000
	(Record Purchase Returns & Allowances)			**(Record Purchase Returns & Allowances)**		
	Transportation-in	75		Merchandise Inventory	75	
	Cash		75	Cash		75
	(Record Transportation Cost)			**(Record Transportation Cost)**		

3.3 Accounting for Merchandise Sales:

Merchandising companies also must account for sales, sales discount, sales return and allowances, and cost of goods sold. Each sales transaction for a seller of merchandise involves two parts. These parts are; **(1)** the revenue received in the form of an asset from a customer, and **(2)** the recognition of the cost of merchandise sold to a customer.

3.3.1) Accounting for Merchandise Sales Under Perpetual System:

Accounting for a sales transaction under the perpetual system requires recording information about both parts. This means that each sales transaction for merchandisers, whether for cash or on credit, requires two entries: One for revenue and one for cost. Using the perpetual inventory system, the cost of merchandise sold and the decrease in merchandise inventory are also recorded.

☑ **Cash Sales:** A business may sell merchandise for cash. Cash sales are normally entered (rung up) on cash register and recorded in the accounts.

Example -12: Assume on January-3, 2011 **Net Solution** sold merchandises costing Birr 1,200 for Birr 1,800 cash to **Awash Company**. The entry will be;

Date	**Explanation**	**Debit**	**Credit**
January-3, 2011	Cash	**1,800**	
	Sales		**1,800**
	(To Record Cash Sales)		
January-3, 2011	Cost of Merchandise Sold	**1,200**	
	Merchandise Inventory		**1,200**
	(To record the cost ofmerchandise sold)		

☑ **Sales on Account:** A business may sell merchandise on account. The seller records such sales as a debit to Accounts Receivable and a credit to Sales.

Example -13: Assume on January-5, 2011 **Net Solutions** sold to **Sims Company** merchandise Birr 510 on account. The cost of the merchandise sold was Birr 280 and on January-16, 2011 **Net Solutions** receives the amount from **Sims Company**. The entry will be;

Date	Explanation	Debit	Credit
January-5, 2011	Accounts Receivable - Sims Company	510	
	Sales		510
	(To Record Credit Sales)		
January-5, 2011	Cost of Merchandise Sold	280	
	Merchandise Inventory		280
	(To record the cost of merchandise sold)		
	Cash	510	
	Accounts Receivable - Sims Company		510
	(To Record Cash Receipt from Credit Sales)		

☑ **Sales Discounts:** The terms of a sale are normally indicated on the invoice or bill that the seller sends to the buyer. The terms for when payments for merchandise are to be made are called the **credit terms**. If payment is required on delivery, the terms are cash or net cash. Otherwise, the buyer is allowed an amount of time, known as the credit period, in which to pay.

The credit period usually begins with the date of the sale as shown on the invoice. If payment is due within a stated number of days after the invoice date, such as 30 days, the terms are net 30 days. These terms may be written as **n/30.** If payment is due by the end of the month in which the sale was made, the terms are written as **n/EOM.** To encourage the buyer to pay before the end of the credit period, the seller may offer a discount. **Example:** a seller may offer a 2% discount if the buyer pays within 10 days of the invoice date. If the buyer does not take the discount, the total amount is due within 30 days. These terms are expressed as 2/10, n/30 and are read as 2% discount if paid within 10 days, net amount due within 30 days.

Sales discount on credit sales can benefit a seller by decreasing the delay in receiving cash and reducing future collection efforts. At the time of credit sale, a seller does not know whether a customer will pay within the discount period and take advantage of a purchase discount. This means the seller usually does not record a sales discount until a customer actually pays within the discount period.

Credit Terms	Explanation of Credit Terms	Amount to be paid
Invoice for Birr 1,500, Terms: 2/10, n/30	If invoice is paid within 10 days of invoice date	Birr 1,470 paid (2% cash discount)
	If invoice is **not** paid within 10 days of invoice	Birr 1,500 paid (full amount)

Example -14: Assume on January-10, 2011 **Net Solutions** sold merchandise inventory cost of Birr 100,000 for Birr 180,000, term 1/10, n/30 and receives the amount due from **Sims Company** on January-22, 2011. The entry will be;

Date	Explanation	Debit	Credit
January-10, 2011;	A/R - Sims Company	180,000	
	Sales		180,000
	(To Record Sales term 1/10, n/30)		
January-22, 2011;	CGS	100,000	
	Inventory		100,000
	(To Record CGS)		
January-10, 2011	Cash	178,200	
	Sales Discount	1,800	
	Accounts Receivable - Sims Co		180,000
	(Received payment for Jan-12 sale less discount)		

Note: sales discount is a contra revenue account that is deducted from the sales account when computing company's net sales.

☑ **Sales Returns and Allowances:** Merchandise sold may be returned to the seller (sales return). In other cases, the seller may reduce the initial selling price (sales allowance). This might occur if the merchandise is defective, damaged during shipment, or does not meet the buyer's expectations. If the return or allowance is for a sale on account, the seller usually issues the buyer a credit memorandum, often called a **credit memo.** A credit memo authorizes a credit to (decreases) the buyer's account receivable. A credit memo indicates the amount and reason for the credit.

Like sales discounts, sales returns and allowances reduce sales revenue. Also, returns often result in additional shipping and handling expenses. Thus, managers usually want to know the amount of returns and allowances for a period. For this reason, sales returns and allowances are recorded in a separate sales returns and allowances account, which is a contra (offsetting) account to Sales. The seller debits Sales Returns and Allowances for the amount of the return or allowance. If the sale was on account, the seller credits Accounts Receivable. Using a perpetual inventory system, the seller must also debit (increase) Merchandise Inventory and decrease (credit) Cost of Merchandise Sold for the cost of the returned merchandises?

- **Sales Return:** Refers to merchandise that customers return to the seller after a sale. Many companies allow customers to return merchandise for a full refund.
- **Sales Allowance:** Refers to reductions in the selling price of merchandise sold to customers. This can occur with damaged or defective merchandise that a customer is willing to purchase with a decrease in selling price. If there is a defect in the product or the wrong item was shipped, the seller may reduce the initial price at which the goods were sold. This is known as a **sales allowance.** Sales returns and allowances usually involve dissatisfied customers and the possibility of lost future sales, and managers need information about returns and allowances to monitor these problems.

Example -15: Assume on Jamuary-12, 2011 **Net Solutions** sold merchandise for Birr 255 that had cost Birr 140 to **ABC Company.** ABC Company returns the merchandise inventory on January-13, 2011. The entry will be;

Date	Explanation	Debit	Credit
January-12, 2011	Accounts Receivable - ABC Company	255	
	Sales		255
	(To Record Credit Sales)		
January-12, 2011	Cost of Merchandise Sold	140	
	Merchandise Inventory		140
	(To record the cost of merchandise sold)		
January-13, 2011	Sales Returns and Allowances	255	
	Accounts Receivable – ABC Company		255
	(Record Sales Returns and Allowances)		
January-13, 2011	Merchandise Inventory	140	
	Cost of Merchandise Sold		140
	(Record Cost of merchandise returned – Credit sale)		

Example -16: Assume on January-15, 2002; **Net Solutions** sold merchandise for Birr 2,400 that had cost Birr 1,600 to its customer. Assuming that the customer returns part of the merchandise on January-15, 2002; and the returned items sell for Birr 800 and cost Birr 600. If the merchandise returned to Net Solutions is not defective and can be resold to another customer, the entry will be;

Date	Explanation	Debit	Credit
January-15, 2011	Accounts Receivable - ABC Company	2,400	
	Sales		2,400
	(To Record Credit Sales)		

	Cost of Merchandise Sold	1,600	
	Merchandise Inventory		1,600
	(To record the cost of merchandise sold)		
January-15, 2011	Sales Returns and Allowances	800	
	Accounts Receivable – ABC Company		800
	(Record Sales Returns and Allowances)		
	Merchandise Inventory	600	
	Cost of Merchandise Sold		600
	(Record Cost of merchandise returned – Credit sale)		

Note that: if the goods returned are defective-that is, the returned inventory is recorded at its estimated value, not its cost.

Example -17: Assume on January-15; if the goods costing Birr 600 returned to **Net Solutions** are defective and estimated to be worth Birr 150, the following entry is made;

Date	Explanation	Debit	Credit
January-15, 2011	Merchandise Inventory	150	
	Loss from Defective Merchandise	450	
	Cost of Merchandise Sold		600
	(Returned Goods Added To Inventory & Defective Portion)		

Example -18: Assume that Birr 800 of the merchandise **Net Solutions** sold on January-15, 2011 is defective but the buyer decides to keep it because Net Solutions offers a Birr 100 price reduction. Net Solutions records the allowance and decreases expected assets as follows;

Date	Explanation	Debit	Credit
January-15, 2011	Sales Return and Allowance	100	
	Accounts Receivable		100
	(Returned Sales Returned – from January-15, 2011 sale)		

Note: The seller usually prepares a credit memorandum to confirm a buyer's return or allowance. A seller's **credit memorandum** informs a buyer of the seller's credit to the buyer's Account Receivable (on the seller's book).

☑ **Sales Taxes:** Almost all states levy a tax on sales of merchandise. The liability for the sales tax is incurred when the sale is made. At the time of a cash sale, the seller collects the sales tax. When sale is made **on account,** the buyer is charged for the tax. The seller credits the sales account for only amount of sale and credits the tax to sales tax payable (for the buyer).

Example -19: Assume on January-20, 2011, **Net Solutions** sold merchandise for Birr 100 to **Lemon Company** on account. The state has a 6% sales tax. The entry will be;

Date	Explanation	Debit	Credit
January-20, 2011	Accounts Receivable - Lemon Company	106	
	Sales		100
	Sales Taxes Payable		6
	(Record sales and Sale Taxes)		

Example -20: Assume on Feburaury-20, 2011; **Net Solutions** sends in a payment of Birr 2,900 to the taxing unit for the January taxes collected. The entry will be;

Date	Explanation	Debit	Credit
Feburaury-20, 2011;	Sales Tax Payable	2,900	
	Cash		2,900
	(Payment for sales taxes collected during August)		

Example -21: Assume **Yahoo Company** sold merchandise inventory cost of Birr 28,000 for Birr 40,000 to **Delina Company** on December-1, 2011 for cash, sold merchandise inventory cost of Birr 250,000 for Birr 300,000 to **Delila Company** on December-2, 2011, **term, 1/10, n/60,** received Birr 100,000 merchandise inventory returned on December-4, 2011 which costs were Birr 85,000, made price adjustment of Birr 10,000 for those additional

defective items of Birr 25,000 which costs were Birr 17,000 and received payment from **Delila Company** on December-11, 2011 and received payment on December-12, 2011. The entry will be;

Date	Explanation	Debit	Credit
December-1, 2011;	Cash	40,000	
	Sales		40,000
	(To Record Purchase of Merchandise Inventory for Cash)		
	CGS	28,000	
	Inventory		28,000
	(To Record CGS)		
December-2, 2011;	A/R - Delila Company	300,000	
	Sales		300,000
	(To Record Credit Sales, term 1/10, n/60)		
	CGS	250,000	
	Inventory		250,000
	(To Record CGS)		
December-4, 2011;	Sales Return & Allowance	100,000	
	A/R - Delila Company		100,000
	(To Record Sales Return & Allowance - Returned)		
	Inventory	85,000	
	CGS		85,000
	(To Record CGS Returned)		
December-6, 2011;	Sales Return & Allowance	10,000	
	A/R - Delila Company		10,000
	(To Record Sales Return & Allowance – Allowances)		
	Inventory	17,000	
	CGS		17,000
	(To Record CGS Returned)		
December-11, 2011;	Cash	188,100	
	Sales Discount	1,900	
	A/R - Delila Company		190,000
	(To Record Cash Receipt With Discount Period)		
December-12, 2011;	Cash	190,000	
	A/R - Delila Company		190,000
	(To Record Cash Receipt Without Discount Period)		

3.3.2) Accounting for Merchandise Sales Under Periodic System:

In the periodic inventory system, sales are recorded in the same manner as in the perpetual inventory system. However, cost of merchandise sold is not recorded on the date of sale. Instead, cost of merchandise sold is determined as follows;

Total Cost of Merchandise Purchases is Computed as Follows:				
	Invoice cost of merchandise purchases			xxx
Less:	Purchase returns and allowance			(xx)
	Purchase discount received			(xx)
	Net purchases			xxx
Add:	Costs of transportation-in			xx
	Total Cost of Merchandise Purchases			**xxx**
Total Cost of Merchandise Sold is Computed as Follows:				
	Merchandise Inventory (beginning)			xxx
	Invoice cost of merchandise purchases	xxx		
Less:	Purchase discount received	(xx)		
	Purchase returns and allowance	(xx)		
	Net purchases		**xxx**	
Add:	Costs of transportation-in		xx	
	Total cost of merchandise purchased			**xxx**
	Merchandise available for sale			xxx
Less:	Merchandise Inventory (ending)			(xxx)
	Cost of Merchandise Sold			**xxxx**

Gross Profit is Computed as follows:				
	Sales			xxx
Less:	Sales discount			(xx)
	Sales returns & Allowances			(xx)
	Net Sales			**xxx**
Less:	Cost of Goods Sold			(xx)
	Gross Profit			**xxx**

Example -22: Assume **Yahoo Company** sold merchandise inventory Birr 10,000 to **ABC Company** on December-1, 2010 for cash, sold merchandise inventory Birr 100,000 to **ABC Company** on December-2, 2010, **term 2/10, n/30,** received Birr 10,000 merchandise inventory returned on December-4, 2010, on December-6, 2010 made price adjustment of Birr 1,000 for those additional defective items of Birr 2,000 and received payment from **ABC Company** on December-11, 2010 for credit sales of December-2, 2010. The entry will be;

Date	Explanation	Debit	Credit
December-1, 2010;	Cash	10,000	
	Sales		10,000
	(To Record Cash Sales)		
December-2, 2010;	A/R - ABC Company	100,000	
	Sales		100,000
	(To Record Credit Sales – term 2/10, n/30)		
December-4, 2010;	Sales Return & Allowance	10,000	
	A/R - ABC Company		10,000
	(To Record Sales Return & Allowance – Returned)		
December-6, 2010;	Sales Return & Allowance	1,000	
	A/R - ABC Company		1,000
	(To Record Sales Return & Allowance – Allowances)		
December-11, 2010;	Cash	87,220	
	Sales Discount	1,780	
	A/R - ABC Company		89,000
December-12, 2010	**(To Record Cash Receipt With Discount Period)**		
	Cash	89,000	
	A/R - ABC Company		89,000
	(To Record Cash Receipt Without Discount Period)		

Example -23: Assume on Feburaury-25, 2011 **Net Solutions** sold merchandise Birr 16,000 on account with terms 2/10, n/30 to **Marathon Company**. The cost of the merchandise sold was Birr 9,600. Marathon Company pays the amount on March-5, 2011. The necessary entry will be;

Date	Explanation	Debit	Credit
Feburaury-25, 2011	Accounts Receivable - Marathon Company	16,000	
	Sale		16,000
	(Record Sales of Merchandise Inventory on Credit)		
March-5, 2011	**Cash**	15,680	
	Sales Discount	320	
	Accounts Receivable - Marathon Company		16,000
	(Record Cash Reciept)		

Example -24: Assume on March-6, 2011 **Net Solutions** sold merchandise Birr 41,000 on account with terms 1/10, n/30 to **Marathon Company**. The cost of the merchandise sold was Birr 22,500. March-7, 2011 Marathon Company returns merchandise which sales price was Birr 10,000 and their cost was Birr 5,500. Marathon Company pays the amount on March-16, 2011. The necessary entry will be;

Date	Explanation	Debit	Credit
March-6, 2011	Accounts Receivable - Marathon Company	41,000	
	Sales		41,000
	(Record Sales of Merchandise Inventory on Credit)		
March-7, 2011	Sales Return & Allowance -	10,000	

	Accounts Receivable - Marathon Company		10,000
	(Record Sales Return & Allowance - Marathon Company)		
March-16, 2011	Cash	30,690	
	Sales Discount	310	
	Accounts Receivable - Marathon Company		31,000
	(Record Cash Receipt from - Marathon Company)		

3.3.3) Transportation Costs and Ownership Transfer:

The buyer and seller must agree on who is responsible for paying and freight costs and who bears the risk of loss during transit for merchandising transactions. This is essentially the same as asking at what point ownership transfers from the seller to the buyer. The point of transfer is called the **FOB** (free on board) point, which determines who pays transportation costs (and often other incidental costs of transit such as insurance). There are two alternative points of transfer:

- **FOB Shipping Point:** Also called FOB factory, mean the buyer accepts ownership when the goods depart the seller's place of business. Title passes to buyer as shipment leaves shipping point. The buyer is responsible for shipping costs and bearing the risk of damage or loss when goods are in transit. Buyer pays freight costs and debits **Merchandise Inventory.** The cost principle requires that any necessary transportation costs of a buyer (often called transportation-in or freight-in) be included as part of the cost of purchased merchandise. The goods are part of the buyer's inventory when they are in transit since ownership has transferred to the buyer.

Example -25: Assume on June-10, 2011; **Net Solutions** buys merchandise from **Magna Data** on account, Birr 900, terms FOB shipping point and pays the transportation cost of Birr 50. The entry under both will be;

	Net Solutions (Buyer)			**Magna Data (Seller)**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
June-10, 2011	Merchandise Inventory	900		A/R - Net Solutions	900	
	Accounts Payable - Magna Data		900	Sales		900
	(To Record Purchased merchandise, FOB shipping)			**(To Record Credit Sales)**		
June-10, 2011	Merchandise Inventory	50		**No Entry**		
	Cash		50			
	(To Record Transportation Cost)					

- **FOB Destination:** Means ownership of goods transfers to the buyer when the goods arrive at the buyer's place of business. Title passes to buyer upon arrival at destination. The seller is responsible for shipping charges and bears the risk of damage or loss in transit. Seller pays freight costs and debits **Transportation-Out or fright-out or delivery expense,** reported as selling expense in the seller's income statement. The **seller does not record revenue from this sale until the goods arrive at the destination** because this transaction is not complete before that point.

Example -26: Assume on June-15, 2011; **Net Solutions** sells merchandise to **Kranz Company** on account, Birr 700, terms FOB destination. The cost of the merchandise sold is Birr 480. Net Solutions pays the transportation cost of Birr 40. The entry under both will be;

	Net Solutions (Seller);			**Kranz Company (Buyer);**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
June-15, 2011	A/R - Kranz Company	700		Merchandise Inventory	700	
	Sales		700	A/P – Net Solution		700
	(To Record Credit Sales)			**(To Record Credit Purchase)**		
June-15, 2011	CGS	480		**No Entry**		
	Merchandise Inventory		480			
	(To Record CGS)					
	Transportation - out	40				

	Cash		40	**No Entry**
	(To Record Transportation Cost)			

Note: The seller may prepay the freight, even though the terms are FOB shipping point. The seller will then add the freight to the invoice. The buyer debits Merchandise Inventory for the total amount of the invoice, including the freight. Any discount terms would not apply to the prepaid freight. In addition the buyer may repay the fright even the term is FOB destination. Under these issues the recording way of freight cost strictly different.

Example -27: Assume **Net Solutions** sells merchandise on June-20, 2011; to **Planter Company** on account, Birr 800, terms **FOB shipping point**. Net Solutions paid freight of Birr 45, which was added to the invoice. The cost of the merchandise sold is Birr 360. The entry under both (seller & buyer) will be;

	Net Solutions (Seller)			**Planter Company (Buyer)**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
June-20, 2011	A/R - Planter Company	800		Inventory		
	Sales		800	A/P		
	(Sold Merchandise terms FOB shipping point)			**(Record Purchase of Inventory on Credit)**		
June-20, 2011	CGS	360		**No Entry To Record CGS**		
	Inventory		360			
	(Recorded CGS to Planter Company)					
June-20, 2011	A/R - Planter Company			Inventory		
	Cash			A/P		
	(Prepaid shipping cost on merch. Sold)			**(Record shipping cost)**		

Example -28: Assume **ABC Company** bought goods worth Birr 85,000 on account, terms 2/10, n/60; FOB shipping point on March-2, 2001 from **LMM Company.** March-2, 2001 - **LMM Company** was paid transportation cost of Birr 1,500. ABC Company paid the credit on March-31, 2001 full amount. Record the necessary journal entries for the buyer & seller for the period of March 2001, assuming perpetual inventory system;

	LMM Company (Seller);			**ABC Company (Buyer);**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
March-2, 2001	A/R - ABC Company	85,000		Inventory	85,000	
	Sale		85,000	A/P		85,000
	(Sold Merchandise terms FOB shipping point)			**(Record Purchase of Inventory on Credit)**		
March-2, 2001	A/R - ABC Company	1,500		Transportation-in	1,500	
	Cash		1,500	A/P		1,500
	(To Record Transportation Costs)			**(To Record Transportation Costs)**		
March-31, 2001	**Cash**	86,500		A/P	86,500	
	A/P		86,500	Cash		86,500
	(To Record Full Payment)			**(To Record Full Payment)**		

3.3.4) Accounting for Merchandise Transactions Under Seller and Buyer (Examples – Perpetual):

Example -29: Assume on July-1, 2011 **Scully Company** sold merchandise to **Burton Company** Birr 11,000 for cash with terms FOB shipping point. Burton Company paid transportation charges of Birr 500. The cost of the merchandise sold was Birr 8,000. The entry will be;

	Scully Company (Seller);			**Burton Company (Buyer);**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
July-1, 2011	Cash	11,000		Merchandise Inventory	11,000	
	Sales		11,000	Cash		11,000
	(Record Cash Sales)			**(Record Purchase on Cash)**		
July-1, 2011	Cost of Goods Sold	8,000		**No Entry To Record CGS**		
	Merchandise Inventory		8,000			
	(Record Costs of Merchandise Sold)					
July-1, 2011	**No Entry to Record Transportation Cost**			Transportation in	500	
				Cash		500
				(Record Transportation Cost)		

Example -30: Assume on July-2, 2011 **Scully Company** sold merchandise on account to **Burton Company** Birr 7,500, terms FOB shipping point, n/45. July-2, 2011 Burton Company paid transportation charges of Birr 150. The cost of the merchandise sold was Birr 4,500. The entry will be;

	Scully Company (Seller);			**Burton Company (Buyer);**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
July-1, 2011	Accounts Receivable - Burton Company	7,500		Merchandise Inventory	7,500	
	Sales		7,500	Accounts Payable – Scully Com		7,500
	(Record Credit Sales)			**(Record Purchase on Credit)**		
July-1, 2011	Cost of Goods Sold	4,500		**No Entry To Record CGS**		
	Merchandise Inventory		4,500			
	(Record Costs of Merchandise Sold)					
July-1, 2011	**No Entry to Record Transportation Cost**			Merchandise Inventory	150	
				Cash		150
				(Record Transportation Cost)		

Example -31: Assume on July-5, 2011 **Scully Company** sold merchandise on account to **Burton Company** Birr 5,000, terms FOB destination point, n/30 and the cost of the merchandise sold was Birr 3,500. July-7, 2011 Scully Company paid transportation costs of Birr 250 for delivery of merchandise sold to Burton Company on July-5, 2011. July-13, 2011 Scully Company issued Burton Company a credit memorandum for Birr 1,000 of merchandise returned from a July-5, 2011 purchases on account and the cost of the merchandise was Birr 700. July-15, 2011 Scully Company received payment from Burton Company for the sale of July-5, 2011. The necessary entry;

	Scully Company (Seller);			**Burton Company (Buyer);**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
July-5, 2011	Accounts Receivable - Burton Company	5,000		Merchandise Inventory	5,000	
	Sales		5,000	Accounts Payable – Scully		5,000
	(Record Credit Sales)			**(Record Purchase on Credit)**		
	Cost of Goods Sold	3,500		**No Entry To Record CGS**		
	Merchandise Inventory		3,500			
	(Record Costs of Merchandise Sold)					
July-7, 2011	Transportation Out	250		**No Entry to Record Transportation Cost**		
	Cash		250			
	(Record Transportation Cost)					
July-13, 2011	Sales Return & Allowances	1,000		Accounts Payable – Scully	1,000	
	Accounts Receivable - Burton Company		1,000	Merchandise Inventory		1,000
	(Record Sales Return & allowance)			**(Record Purchase Return & Allowance)**		
	Merchandise Inventory			**No Entry**		
	Cost of Goods Sold					
	(Record Costs of Merchandises sold – Returned)					
July-15, 2011	Cash	4,000		Accounts Payable - Scully	4,000	
	Accounts Receivable - Burton Com		4,000	Cash		4,000
	(Record Cash Receipt)			**(record Cash Payment)**		

Example -32: Assume on July-18, 2011 **Scully Company** sold merchandise on account to Burton Company Birr 12,000, terms FOB shipping point, 2/10, n/EOM. Scully prepaid transportation costs of Birr 500 and the cost of the merchandise sold was Birr 7,200. July-28, 2011 Scully Company received payment from Burton Company for the sale of July-18, 2011. The necessary entry will be;

	Scully Company (Seller);			**Burton Company (Buyer);**		
Date	**Explanation**	**Debit**	**Credit**	**Explanation**	**Debit**	**Credit**
July-18, 2011	Accounts Receivable - Burton Company	12,000		Merchandise Inventory	12,000	
	Sales		12,000	Accounts Payable – Scully		12,000
	(Record Credit Sales)			**(Record Credit Purchases)**		
	Accounts Receivable - Burton Company	500		Merchandise Inventory	500	
	Cash		500	Accounts Payable – Scully		500
	(Record Transportation Cost)			**(Record Transportation Cost)**		

	Cash	12,260		Accounts Payable – Scully	12,500	
	Sales Discount	240		Merchandise Inventory		240
	Accounts Receivable - Burton Company		12,500	Cash		12,260
	(Record Cash Receipt Including Transportation)			**(Record Cash Payment)**		

3.4 Chart of Accounts for Merchandise Business:

The chart of accounts under a periodic inventory system and the accounts used to record transactions under the periodic inventory system are highlighted as follow;

Balance Sheet Accounts				**Income Statement Accounts**				
100 Assets				**400 Revenues**		**600 Other Income**		
110	Cash	120	Land	410	Sales	610	Rent Revenue	
111	N/R	123	Store Equipment	411	Sales Return	**700 Other Expense**		
112	A/R	124	Accum Dep –Equip Store	412	Sales Discount	710	Interest Expense	
115	Inventory	125	Office Equipment	**500 Costs & Expenses**				
116	Supplies	126	Accum Dep –Equip Office	510	Purchases	523	Delivery Expense	
117	Insurance			511	Purchases Returns	529	Miscellan Selling Expense	
200 Liabilities		**300 Owner's Equity**		512	Purchases Discount	530	Office Salaries Expense	
210	A/P	310	Chris Clark, Capital	513	Freight In	531	Rent Expense	
211	Salary Payable	311	Chris Clark, Drawing	520	Sales Salary Expens	532	Dep Exp Offic Equip	
212	Unearned Rent	312	Income Summary	521	Advertising Expense	533	Insurance Expense	
215	N/P			522	Dep Exp Stor Equip	534	Supplies Expense	
						539	Misc Administr Expense	

3.5 Financial Statements for Merchandise Business:

The financial statements of merchandiser, and their preparations, are similar to those for a service company described in earlier chapters. The income statement mainly differs by the inclusion of cost of goods sold and grosses profit. Also, net sales are affected by discounts, returns, and allowances and some additional expenses are possible such as delivery expense and loss from defective merchandise. The balance sheet mainly differs by the inclusion of merchandise inventory as part of current assets. The statement of owner's equity is unchanged. A work sheet can be used to help prepare these statements.

- ☞ **Income Statements Formats:** Income statement is a summary of revenues and expenses of a business entity for a specified of time. There are two widely used formats of income statement; multiple step and single step income statements.

☑ **Multiple-Step Income Statement:** A multiple-step income statement format shows detailed computation of net sales and other costs and expenses, and reports subtotals for various classes of items. The statement has three main parts:

A) Gross profit, determined by net sales less cost of goods sold,

B) Income from operations, determined by gross profit less operating expenses, and

C) Net income, determined by income from operations adjusted for non operating items.

Operating expenses are classified into two sections. **Selling expenses** include the expenses of promoting sales by displaying and advertising merchandise, making sales, and delivering goods to customers. **General and administrative expenses** support a company's overall operations and include expenses related to accounting, human resource management, and financial management. Note that expenses are allocated between sections when they contribute to more than one.

Non operating activities consist of other expenses, revenues, losses, and gains that are unrelated to a company's operations. They are reported in two sections; **(1) Other revenues and gains**, which often include interest revenue,

dividend revenue, rent revenue, and gains from asset disposals; and **(2) Other expenses and losses**, which often include interest expense, losses from asset disposals, and casualty losses.

Note: When a company has no reportable non-operating activities, its income from operations is simply labeled net income.

Example -33: Assume **Net Solutions** Prepare its financial statements as follows;

Net Solutions; Income Statement; December 31, 2007 – (Multiple Step);			
	Revenue From Sales:		
	Sales		Birr 720,185
Less:	Sales Returns & Allowances	Birr 6,140	
	Sales Discounts	5,790	(11,930)
	Net Sales		Birr 708,255
Less:	Cost Of Merchandise Sold		(525,305)
	Gross Profit		Birr 182,950
	Operating Expenses:		
	Selling Expenses:		
	Sales Salaries Expense	Birr 56,230	
	Advertising Expense	10,860	
	Depreciation Expense–Store Equipment	3,100	
	Miscellaneous Selling Expense	630	
	Total Selling Expenses	**Birr 70,820**	
	Administrative Expenses:		
	Office Salaries Expense	Birr 21,020	
	Rent Expense	8,100	
	Depreciation Expense–Office Equipment	2,490	
	Insurance Expense	1,910	
	Office Supplies Expense	610	
	Miscellaneous Administrative Expense	760	
	Total Administrative Expenses	**Birr 34,890**	
	Total Operating Expenses		**(Birr 105,710)**
	Income From Operations		Birr 77,240
	Other Income And Expenses:		
	Rent Revenue	600	
	Interest Expense	(2,440)	(1,840)
	Net Income		**Birr 75,400**
	Note: Cost of Merchandise Purchased is Computed as:		
	Purchases		Birr 521,980
Less:	Purchase return & allowance	9,100	
	Purchase discount	2,525	(11,625)
	Net purchases		**Birr 510,355**
Add:	Transportation-in		17,400
	Cost of merchandise purchased		**Birr 527,755**
	Note: Cost of Merchandise Sold is Computed as:		
	Merchandise Inventory (Beginning)		Birr 59,700
Add:	Cost of Merchandise Purchased		527,755
	Merchandise Available for Sale		587,455
Less:	Merchandise Inventory (Ending)		(62,150)
	Cost of Merchandise Sold		**Birr 525,305**

☑ **Single-Step Income Statement for a Merchandising Business:** A **single-step income statement** is another widely used format that lists cost of goods sold as another expense and shows only one subtotal for total expenses. Expenses are grouped into very few, if any categories. Many companies use formats that combine features of both the single-and multiple-step statements.

Net Solutions; Income Statement; December 31, 2007 – (Single Step);			
	Revenues:		
	Net Sales Revenues	Birr 708,255	
Add:	Rent Revenue	600	

	Total Revenues		**Birr 708,855**
	Expenses:		
	Cost Of Merchandise Sold	Birr 525,305	
	Selling Expenses	70,820	
	Administrative Expenses	34,890	
	Interest Expense	2,440	
	Total Expenses		**(Birr 633,455)**
	Net Income		**Birr 75,400**
Net Solutions; Statement of Owner's Equity; December 31, 2007;			
	Chirs Clark, capital, 1/1/07		Birr 153,800
	Net income for the year	75,400	
Less:	Withdrawals	(18,000)	
	Increase in owner's equity		57,400
	Chirs Clark, capital, 12/31/07		**Birr 211,200**

Net Solutions; Balance Sheet; December 31, 2007;

Assets			**Liabilities & Owner's Equity**		
Current Assets:			**Current Liabilities:**		
Cash		52,950	A/P		22,420
Account Receivable		91,080	N/P		5,000
Merchandise Inventory		62,150	Salaries payable		1,140
Office Supplies		480	Unearned rent		1,800
Total Current Assets		**206,660**	Total current liabilities		**Birr 30,360**
Property, Plant, & Equipment:			**Long Term Liabilities:**		
Land		20,000	Note payable (due 2010)		20,000
Store Equipment	27,100		**Total Liabilities**		**Birr 50,360**
Less: Accumulated Depreciation	(5,700)	21,400	**Owner's Equity:**		
Office Equipment	15,570		Chris Clark, capital		211,200
Less: Accumulated Depreciation	(4,720)	10,800	**Total Liability & O's Equity**		**Birr 261,560**
Total Property, Plant, & Equipment		**Birr 52,250**			
Total Assets		**Birr 261,560**			

3.6 Adjusting and Closing Entries for Merchandise Business:

Adjusting entries are generally the same for merchandising companies and service companies. However, a merchandiser using a perpetual inventory system is usually required to make another adjustment to update the merchandise inventory account to reflect any loss of merchandise, including theft and deterioration. **Shrinkage** is the term used to refer to the loss of inventory and it is computed by comparing a physical count of inventory with recorded amounts. A physical count is usually performed at least once annually.

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. However, retailers normally experience some loss of inventory due to shoplifting, employee theft, or errors. 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.

Example -34: Assume **Net Solutions'** records indicate on December-31, 2011 account balance of merchandise inventory Birr 63,950 but physical merchandise inventory reveals that on hand Birr 62,150. At the end of the accounting period, inventory shrinkage is recorded by the following adjusting entry;

Date	**Explanation**	**Debit**	**Credit**
Dec. 31	Cost of Goods sold	1,800	
	Merchandise Inventory		1,800
	(Adjusting Entry for Inventory shrinkage - 63,950 – 62,150)		

After the preceding entry is recorded, the balance of Merchandise Inventory agrees with the physical inventory on hand at the end of the period. Since inventory shrinkage cannot be totally eliminated, it is considered a normal cost

of operations. If, however, the amount of the shrinkage is unusually large, it may be disclosed separately on the income statement. In such cases, the shrinkage may be recorded in a separate account, such as Loss from Merchandise Inventory Shrinkage.

Example -35: Assume that **Net Solution's** merchandise inventory account at the end of the year has a balance of Birr 21,250, but a physical count reveals that only Birr 21,000 of inventory exists. The adjusting entry to record this Birr 250 shrinkage is as follows:

Date	Explanation	Debit	Credit
Dec. 31	Cost of Goods sold	250	
	Merchandise Inventory		250
	(To adjust for Birr 250 shrinkage reveled by a physical count of inventory)		

Closing entries for a merchandising business are similar to those for a service business. The four closing entries for a merchandising business are as follows;

(1) Debit each temporary account with a credit balance, such as Sales, for its balance and credit Income Summary.

(2) Credit each temporary account with a debit balance, such as the various expenses, and credit Income Summary. Since Sales Returns and Allowances, Sales Discounts, and Cost of Merchandise Sold are temporary accounts with debit balances, they are credited for their balances.

(3) Debit Income Summary for the amount of its balance (net income) and credit the owner's capital account. The accounts debited and credited are reversed if there is a net loss.

(4) Debit the owner's capital account for the balance of the drawing account and credit the drawing account

After the closing entries are posted to the accounts, a post-closing trial balance is prepared. The only accounts that should appear on the post-closing trial balance are the asset, contra asset, liability, and owner's capital accounts with balances. These are the same accounts that appear on the end-of-period balance sheet. If the two totals of the trial balance columns are not equal, an error has occurred that must be found and corrected.

Example -36: Assume **Net Solutions'** Closing entries have been presented as follows;

Date	Explanation	Ref	Debit	Credit
	Sales	410	720,185	
	Rent Revenue	610	600	
	Income Summary	312		720,785
	(Closing Revenue Accounts)			
	Income Summary	312	645,385	
	Sales Returns and Allowances	411		6,140
	Sales Discounts	412		5,790
	Cost of Merchandise Sold	510		525,305
	Sales Salaries Expense	520		53,430
	Advertising Expense	521		10,860
	Depreciation Expense - Store Equipment	522		3,100
	Delivery Expense	523		2,800
	Miscellaneous Selling Expense	529		630
	Office Salaries Expense	530		21,020
	Rent Expense	531		8,100
	Depreciation Expense - Office Equipment	532		2,490
	Insurance Expense	533		1,910
	Office Supplies Expense	534		610
	Misc. Administrative Expense	539		760
	Interest Expense	710		2,440
	(Closing Expense Accounts)			
	Income Summary	312	75,400	
	Chris Clark, Capital	310		75,400
	(Closing Income Summary Account)			
	Chris Clark, Capital	310	18,000	
	Chris Clark, Drawing	311		18,000
	(Closing Withdrawal Account)			