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Current Assets: Part I

Larry M. Walther; Christopher J. Skousen

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Larry M. Walther

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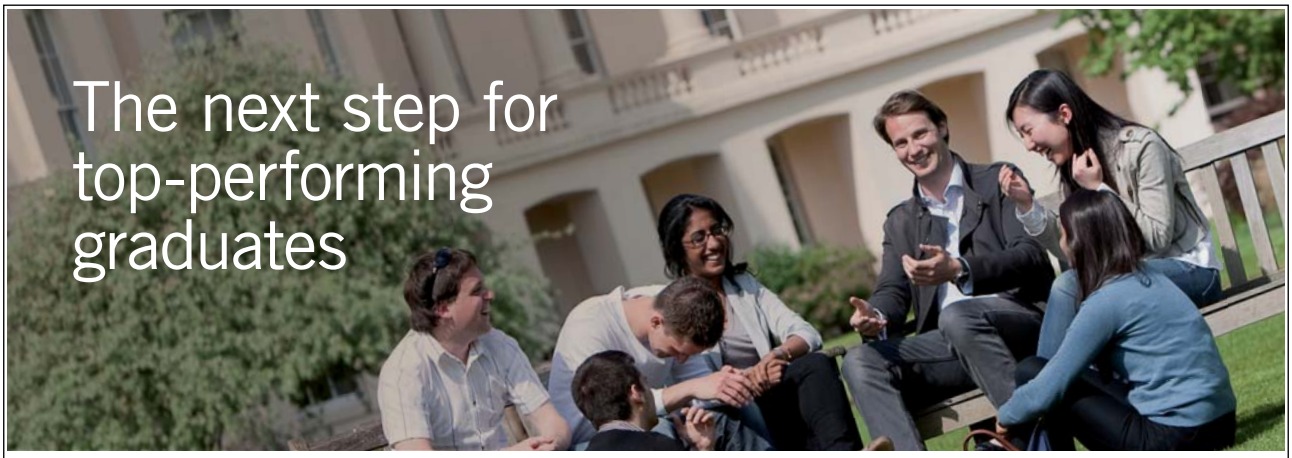

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Part 1
Special Issues for Merchants

Your goals for this "merchandising" chapter are to learn about:

- Merchandising businesses and related sales recognition issues.
- Purchase recognition issues for the merchandising business.
- Alternative inventory system: The perpetual method.
- Enhancements of the income statement.
- The control structure.

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1. The Merchandising Operation - Sales

The discussion and illustrations in the earlier chapters were all based on businesses that generate their revenues by providing services (like law firms, lawn services, architects, etc.). Service businesses are a large component of an advanced economy. However, we also spend a lot of time in the stores or on the internet, buying the things we want or need. Such businesses are generally referred to as "merchants," and their business models are generally based upon purchasing inventory and reselling it at a higher price to customers.

Therefore, this chapter shifts focus from the service business to the merchandising business. Measuring income and reporting it on the income statement involves unique considerations. The most obvious issue is the computation and presentation of an amount called "gross profit." Gross profit is the difference between sales and cost of goods sold, and is reported on the income statement as an intermediate amount. Observe the income statement for Chair Depot below. The gross profit number indicates that the company is selling merchandise for more than cost ($200,000 in sales was generated from goods that cost $120,000 to buy). Of course, the company also incurred other operating expenses; advertising, salaries, and rent. Nevertheless, the gross profit was sufficient to easily cover those costs and leave a tidy profit to boot. The presentation of the gross profit information is very important for users of the financial statements to get a clear picture of operating success. Obviously, if the gross profit rate is small, the business might have trouble making a profit, even if sales improved. Quite the reverse is true if the gross profit rate is strong; improved sales can markedly improve the bottom-line net income (especially if operating expenses like rent, etc., don't change with increases in sales)! It is easy to see why separating the gross profit number from the other income statement components is an important part of reporting for the merchandising operation..

CHAIR DEPOT
Income Statement
For the Year Ending December 31, 20X3

Sales		$200,000
Cost of goods sold		120,000
Gross profit		$ 80,000
Expenses		
Advertising	$ 6,000	
Salaries	9,000	
Rent	5,000	20,000
Net income		$ 60,000

1.1 Sales

The Sales account is a revenue account used strictly for sales of merchandise. Sales are initially recorded via one of the following entries, depending on whether the sale is for cash or on account:

Cash sale:

1-5-X5	Cash	4,000	
	Sales		4,000
	Sold merchandise for cash		

Sale on account:

1-5-X5	Accounts Receivable	4,000	
	Sales		4,000
	Sold merchandise on account		

1.2 Sales Returns and Allowances

Occasionally, a customer returns merchandise. When that occurs, the following entry should be made:

1-9-X5	Sales Returns and Allowances	1,000	
	Accounts Receivable		1,000
	Customer returned merchandise previously purchased on account		

Notice that the above entry included a debit to Sales returns and allowances (rather than canceling the sale). The Sales returns and allowances account is a contra-revenue account that is deducted from sales; sales less sales returns and allowances is sometimes called "net sales." This approach is deemed superior because it allows interested parties to easily track the level of sales returns in relation to overall sales. Importantly, this presentation reveals information about the relative level of returns and provides a measure of customer

CHAIR DEPOT
Income Statement
For the Year Ending December 31, 20X3

Sales	$200,000
Less: Sales returns and allowances	10,000
Net sales	$190,000
Cost of goods sold	114,000
Gross profit	$ 76,000
⋮	⋮

NET SALES

satisfaction or dissatisfaction. Sales returns (on account) are typically documented by the creation of an instrument known as a credit memorandum. The credit memorandum indicates that a customer's account receivable balance has been credited (reduced), and that payment for the returned goods is not expected. If the preceding transaction involved a cash refund, the only difference in the entry would involve a credit to cash instead of accounts receivable. The calculation of net sales would be unaffected.

Note that use of the word "allowances" in the account title "Sales Returns and Allowances." What is the difference between a return and an allowance? Perhaps a customer's reason for wishing to return an item is because of a minor defect; they may be willing to keep the item if the price is slightly reduced. The merchant may give them an allowance (e.g., a reduction in the price they previously agreed to) to induce them not to return the item. The entry to record an allowance would be identical to that above for the agreed amount of the price reduction, and the customer would keep the inventory item. (Of course, one could use a separate account for returns and another for allowances if they wished to track information about each of these elements.)

1.3 Trade Discounts

Product catalogs often provide a "list price" for an item. Oftentimes those list prices bear little relation to the actual selling price. A merchant may offer customers a trade discount that involves a reduction from the catalog or list price. Ultimately, the purchaser is responsible for the invoice price, that is, the list price less the applicable trade discount. Trade discounts are not entered in the accounting records. They are not considered to be a part of the sale because the exchange agreement was based on the reduced price level. Remember the general rule: sales are recorded when an exchange takes place, based on the exchange price. Therefore, the amount recorded as a sale is the invoice price. The entries above (for the $4,000 sale) would still be appropriate if the list price was $5,000, subject to a 20% trade discount.

1.4 Credit Cards

In the retail trade, merchants often issue credit cards. Why? Because they induce people to spend, and interest charges that may be assessed can themselves provide a generous source of additional profit. However, these company issued cards introduce many added costs: customers that don't pay (known as bad debts), maintenance of a credit department, periodic billings, and so forth. To avoid the latter, many merchants accept other forms of credit cards like American Express, Master Card, and so forth. When a merchant accepts these cards, they are usually paid instantly by the credit card company (net of a service charge that is negotiated in the general range of 1% to 3% of the sale). The subsequent billing and collection is handled by the credit card company. Many merchants will record the full amount of the sale as revenue, and then recognize an offsetting expense for the amount charged by the credit card companies.

1.5 Cash Discounts

Merchants often sell to other businesses. For example, assume that Barber Shop Supply sells equipment to various barber shops on open account (i.e., a standing agreement to extend credit for purchases). In these settings, the seller would like to be paid promptly after billing, and may encourage prompt payment by offering a cash discount (also known as a sales discount).

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There is a catch, though. To receive the cash discount, the buyer must pay the invoice promptly. The amount of time one has available to pay is expressed in a unique manner, such as 2/10, n/30 -- these terms mean that a 2% discount is available if the invoice is paid within 10 days, otherwise, the net amount is expected to be paid within 30 days. Assume that Barber Shop Supply sold goods for $1,000, subject to terms of 2/10, n/ 30. The following entry would be recorded at the time of sale:

5-11-X4	Accounts Receivable		1,000	
	Sales			1,000
	Sold merchandise on account, terms 2/10, n/30			

The invoice that would be issued by Barber Shop Supply is illustrated on the next page. Take special note of the invoice date, terms, and invoice amount.

BARBER SHOP SUPPLY
987 Industrial Blvd.
Chicago, IL 12345

Invoice #88765

BILL TO: Tomas Mueller
Hair Port Landing
111 Style Lane, Suite 15
Dallas, TX 99889

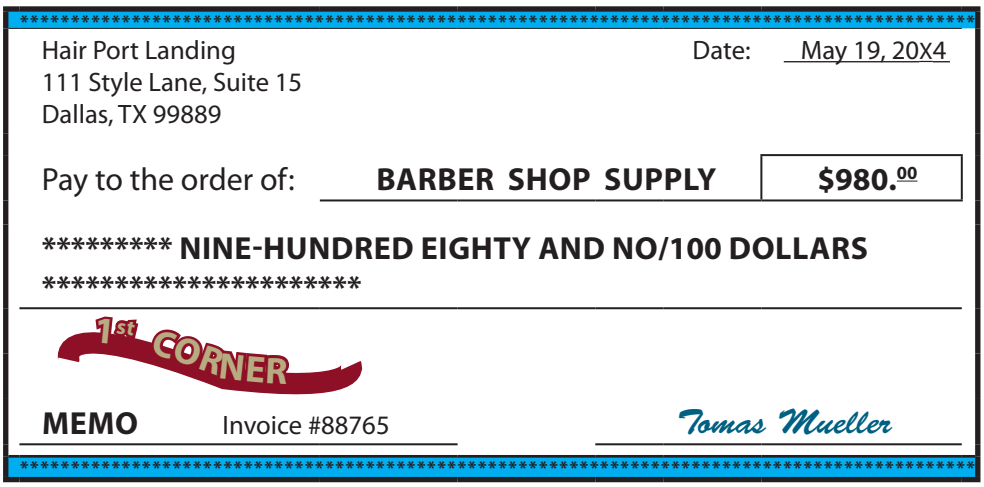
DATE

TERMS

P.O. NUMBER	INVOICE DATE	F.O.B. POINT	TERMS
66554f8	MAY 11, 20X4	Dallas	2/10,n/30

QTY.	PART #	DESCRIPTION	UNIT PRICE	TOTAL
4	A7786	Full Length Mirrors	$ 90	$ 360
1	C8876	Swivel Chair -- Brown Leather	500	500
1	M8776	Barber Pole Motor and Light Kit	140	140
		THANK YOU FOR YOUR BUSINESS!		
			Subtotal	$1,000
			Sales Tax	-
			Shipping and Handling	-
			Other	-
			TOTAL	$1,000

If Hair port landing pays the invoice in time to receive the discount, the check below for $980 would be received by Barber Shop Supply, and recorded via the following entry. This entry reflects that the customer took advantage of the discount terms by paying within the 10-day window. Notice that the entry reduces accounts receivable for the full invoice amount because the payment satisfied the total obligation. The discount is recognized in a special Sales Discount account. The discount account would be reported in like manner to the Sales Returns and Allowance account presented earlier in this chapter.


Hair Port Landing
111 Style Lane, Suite 15
Dallas, TX 99889

Date: May 19, 20X4

Pay to the order of: BARBER SHOP SUPPLY $980.00

********* NINE-HUNDRED EIGHTY AND NO/100 DOLLARS **********

1st CORNER

MEMO Invoice #88765

Tomas Mueller

5-19-X4	Cash		980	
	Sales Discounts		20	
	Accounts Receivable			1,000
	Collected outstanding receivable within discount period, 2% discount granted			

If the customer pays too late to get the discount, then the payment received should be for the full invoice amount, and it would be recorded as follows:

5-29-X4	Cash		1,000	
	Accounts Receivable			1,000
	Collected outstanding receivable outside of the discount period			

Having looked at several of the important and unique issues for recognizing sales transactions of merchandising businesses, it is now time to turn to the accounting for purchasing activities.

2. Purchase Considerations for Merchandising Business

A quick stroll through most any retail store will reveal a substantial investment in inventory. Even if a merchant is selling goods at a healthy profit, financial difficulties can creep up if a large part of the inventory remains unsold for a long period of time. Goods go out of style, become obsolete, and so forth. Therefore, a prudent business manager will pay very close attention to inventory content and level. There are many detailed accounting issues that pertain to inventory, and a separate chapter is devoted exclusively to inventory issues. This chapter's introduction is brief, focusing on elements of measurement that are unique to the merchant's accounting for the basic cost of goods.

2.1 Merchandise Acquisition

The first phase of the merchandising cycle occurs when the merchant acquires goods to be stocked for resale to customers. The appropriate accounting for this action requires the recording of the purchase. Now, there are two different techniques for recording the purchase -- depending on whether a periodic system or a perpetual system is in use. Generalizing, the periodic inventory system is easier to implement but is less robust than the "real-time" tracking available under a perpetual system. Conversely, the perpetual inventory system involves more "systemization" but is a far superior business management tool. Let's begin with the periodic system; we'll then return to the perpetual system.

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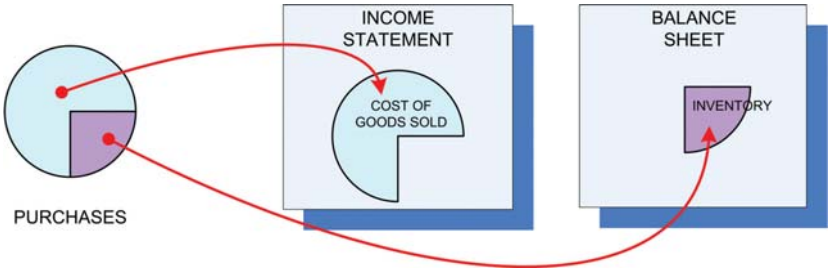
2.2 Periodic Inventory System

When a purchase occurs and a periodic inventory system is in use, the merchant should record the transaction via the following entry:

7-7-X1	Purchases		3,000	
	Accounts Payable			3,000
	Purchased inventory on account			

The Purchases account is unique to the periodic system. The Purchases account is not an expense or asset, per se. Instead, the account's balance represents total inventory purchased during a period, and this amount must ultimately be apportioned between cost of goods sold on the income statement and inventory on the balance sheet. The apportionment is based upon how much of the purchased goods are resold versus how much remains in ending inventory. Soon, you will see the accounting mechanics of how this occurs. But, for the moment, simply focus on the concepts portrayed by this graphic:



2.3 Purchase Returns and Allowances

Recall the earlier discussion of sales returns and allowances. Now, the shoe is on the other foot. Let's see how a purchaser of inventory would handle a return to its vendor/supplier. First, it is a common business practice to contact the supplier before returning goods. Unlike the retail trade, transactions between businesses are not so easily undone. A supplier may require that you first obtain an "RMA" or "Return Merchandise Authorization." This indicates a willingness on the part of the supplier to accept the return. When the merchandise is returned to a supplier a debit memorandum may be prepared to indicate that the purchaser is to debit their Accounts Payable account; the corresponding credit is to Purchases Returns and Allowances:

7-19-X1	Accounts Payable		1,000	
	Puchase Returns and Allowances			1,000
	To record the return of defective inventory to vendor			

Purchase returns and allowances are subtracted from purchases to calculate the amount of net purchases for a period. The specific calculation of net purchases will be demonstrated after a few more concepts are introduced.

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2.4 Cash Discount

Recall the previous discussion of cash discounts (sometimes called purchase discounts from the purchaser's perspective). Discounts are typically very favorable to the purchaser, as they are designed to encourage early payment. While discounts may seem slight, they usually represent a substantial savings and should usually be taken. Consider the calendar on the facing page, assuming a purchase was made on May 1, terms 2/10, n/ 30. The discount can be taken if payment is made within the "green shaded" days (or potentially one additional day, depending on the specific agreement). The discount cannot be taken during the yellow shaded days (of which there are twenty, as noted). The bill becomes past due during the "red shaded days." What is important to note here is that skipping past the discount period will only achieve a 20-day deferral of the payment. If you consider that you are "earning" a 2% return by paying 20 days early, it is indeed a large savings. Consider that there are more than 18 twenty-day periods in a year (365/20), and, at 2% per twenty-day period, this equates to over a 36% annual interest cost equivalent.

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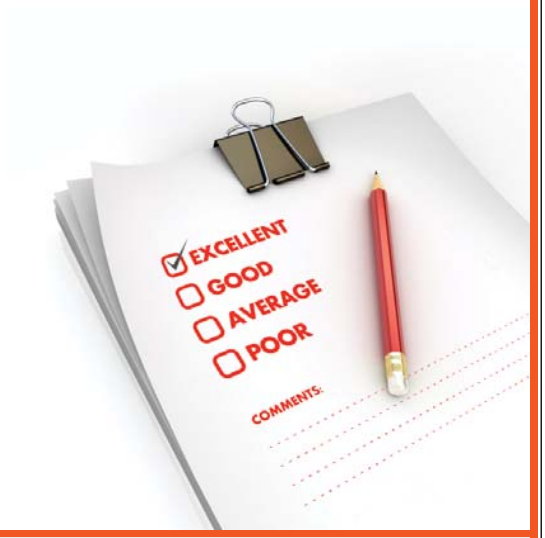

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Discount terms vary considerably. Here are some examples:

- 1/15, n/ 30 -- 1% if paid within 15 days, net in 30 days
- 1/10, n/ eom -- 1% if paid within 10 days, net end of month
- .5/10, n/ 60 -- ½% if paid within 10 days, net in 60 days

Occasionally, a company may opt to skip a discount. In the case of the half-percent discount example, notice that the net amount is not due until the 60th day. Perhaps the purchaser would conclude that the additional 50 days is worth forgoing the half-percent savings, as the annual interest cost equivalent is only about 3.65% (365/50 = 7.3 "periods" per year -- times 0.5% per "period"). But, this is the exception rather than the rule. In short, taking the discounts usually makes good economic sense!

A business should set up its accounting system to timely process and take advantage of all reasonable discounts. In a small business setting, this might entail using a hanging-file system where invoices are filed for payment to match the discount dates. A larger company will usually have an automated payment system where checks are scheduled to process concurrent with invoice discount dates. Very large payments, and global payments, are frequently set up as "wire transfers." This method enables the purchaser to retain use of funds (and the ability to generate investment income on those funds) until the very last minute. This is considered to be a good business practice.

However, there is an ethical issue for you to consider. Many vendors will accept a "discounted payment" outside of the discount period. In other words, a purchaser might wait 30, 60, or 90 days and still take the discount! Some vendors are glad to receive the payment and will still grant credit for the discount. Others will return the payment and insist on the full amount due. Is it a good business practice to "bend the terms" of the agreement to take a discount when you know that your supplier will stand for this practice? Is it ethical to "bend the terms" of the agreement? If you discuss this with your classmates, you will find a diversity of opinion.

2.5 Cross Recording of Purchases/Discounts

A fundamental accounting issue is how to account for purchase transactions when discounts are offered. One technique is the gross method of recording purchases. This technique records purchases at their total gross or full invoice amount:

11-5-X7	Purchases	5,000	
	Accounts Payable		5,000
	Purchased inventory on account, terms 2/10, n/30		

If payment is made within the discount period, the purchase discount is recognized in aseparate account. The Purchase Discounts account is similar to Purchases Returns & Allowances, as it is deducted from total purchases to calculate the net purchases for the period:

11-13-X7	Accounts Payable		5,000	
	Purchase Discounts			100
	Cash			4,900
	Paid outstanding payable within discount period, discount taken ($5,000 X 2% = $100)			

If payment is made outside the discount period, the entry is quite straightforward:

11-29-X7	Accounts Payable		5,000	
	Cash			5,000
	Paid outstanding payable outside of the discount period			

2.6 Net Recording of Purchases/Discounts Lost

Rather than recording purchases gross, a company may elect to record the same transaction under a net method. With this technique, the initial purchase is again recorded by debiting Purchases and crediting Accounts Payable, but only for the net amount of the purchase (the purchase less the available discount):

11-5-X7	Purchases		4,900	
	Accounts Payable			4,900
	Purchased $5,000 of inventory on account, terms 2/10,n/30			

If payment is made within the discount period, the entry is quite straightforward because the payable was initially established at net of discount amount:

11-13-X7	Accounts Payable		4,900	
	Cash			4,900
	Paid accounts payable within discount period			

If payment is made outside the discount period, the lost discounts are recorded in a separate account. The Purchase Discounts Lost account is debited to reflect the added cost associated with missing out on the available discount amount:

11-29-X7	Accounts Payable		4,900	
	Purchase Discounts Lost		100	
	Cash			5,000
	Paid outstanding payable outside of the discount period			

2.7 Comparison of Gross vs. Net

In evaluating the gross and net methods, notice that the Purchase Discounts Lost account (used only with the net method) indicates the total amount of discounts missed during a particular period. The presence of this account draws attention to the fact that discounts are not being taken; frequently an unfavorable situation. The Purchase Discounts account (used only with the gross method) identifies the amount of discounts taken, but does not indicate if any discounts were missed. For reporting purposes, purchases discounts are subtracted from purchases to arrive at net purchases, while purchases discounts lost are recorded as an expense following the gross profit number for a particular period.

The following diagram contrasts the gross and net methods for a case where the discount is taken. Notice that $4,900 is accounted for under each method. The Gross method reports the $5,000 gross purchase, less the applicable discount. In contrast, the net method only shows the $4,900 purchase amount.

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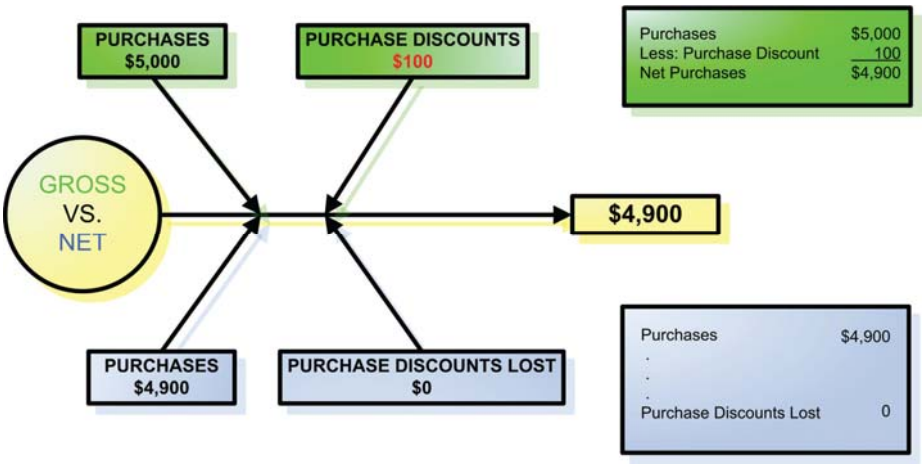
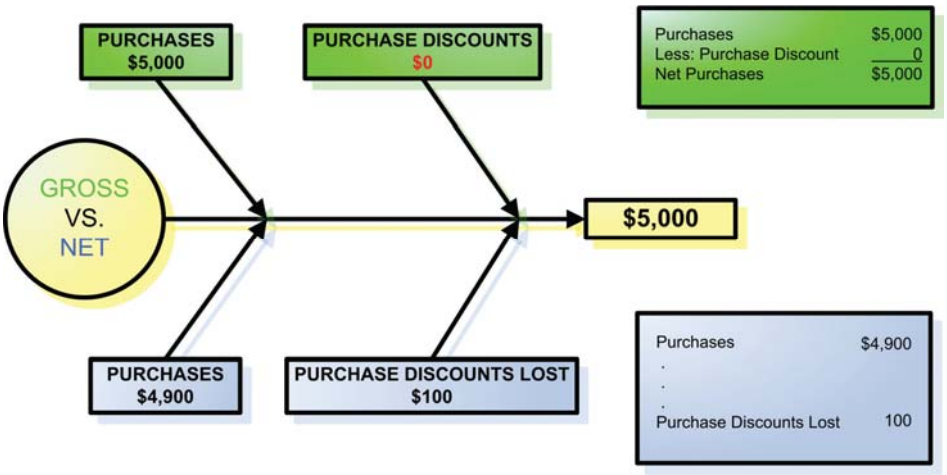
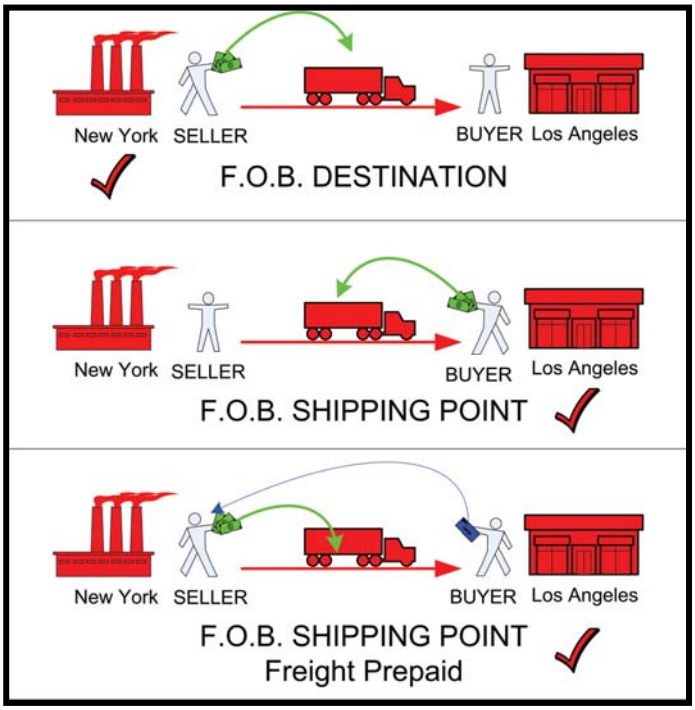


The next diagram contrasts the gross and net methods for the case where the discount is lost. Notice that $5,000 is accounted for under each method. The gross method simply reports the $5,000 gross purchase, without any discount. In contrast, the net method shows purchases of $4,900 and an additional $100 charge pertaining to lost discounts.



2.8 Freight Charges

A potentially significant inventory-related cost pertains to freight. The importance of considering this cost in any business transaction cannot be understated. The globalization of commerce, rising energy costs, and the increasing use of overnight delivery via more expensive air transportation vehicles all contribute to high freight costs. Freight costs can easily exceed 10% of the value of a transaction. As a result, business negotiations relate not only to matters of product cost, but must also include consideration of freight terms. Freight agreements are often described by abbreviations that describe the place of delivery, when the risk of loss shifts from the seller to the buyer, and who is to be responsible for the cost of shipping. One very popular abbreviation is F.O.B. This abbreviation stands for "free on board." Its historical origin apparently related to a seller's duty to place goods on some shipping vessel without charge to the buyer. Whether that historical explanation is exactly correct or not is unclear. What is important is to know is that F.O.B. is a common term.



The F.O.B. point is normally understood to represent the place where ownership of goods transfers. Along with shifting ownership comes the responsibility for the purchaser to assume the risk of loss, a duty to pay for the goods, and the understanding that freight costs beyond the F.O.B. point will be borne by the purchaser.

In the drawing at right, notice that money is paid by the seller to the transport company in the top illustration. This is the case where the terms called for F.O.B. Destination – the seller had to get the goods to the destination. This situation is reversed in the middle illustration: F.O.B. Shipping Point -- the buyer had to pay to get the goods delivered. The third illustration calls for the buyer to bear the freight cost (F.O.B. Shipping Point). However, the cost is prepaid to the trucker by the seller as an accommodation. Notice that the buyer then sends a check (in blue) to the seller to reimburse for the prepaid freight; ultimately the buyer is still bearing the freight cost. Of course, other scenarios are possible. For example, terms could be F.O.B. St. Louis, in which case the seller would pay to get the goods from New York to St. Louis, and the buyer would pay to bring the goods from St. Louis to Los Angeles.

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Take a moment and look at the invoice presented earlier in this chapter for Barber Shop Supply. You will notice that the seller was in Chicago and the purchaser was in Dallas. Just to the right of the invoice date, you will note that the terms were F.O.B. Dallas. This means that Barber Shop Supply is responsible for getting the goods to the customer in Dallas. That is why the invoice included $0 for freight; the purchaser was not responsible for the freight cost. Had the terms been F.O.B. Chicago, then Hair Port Landing would have to bear the freight cost; the cost might be added to the invoice by Barber Shop Supply if they prepaid the cost to a transportation company, or Hair Port might be expected to prepare a separate payment to the transport company. Next are presented appropriate journal entries to deal with alternative scenarios.

- If goods are sold F.O.B. destination, the seller is responsible for costs incurred in moving the goods to their destination. Freight cost incurred by the seller is called freight-out, and is reported as a selling expense that is subtracted from gross profit in calculating net income.

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Seller's entry:

5-11-X4	Accounts Receivable		7,000	
	Freight-out		400	
	Cash			400
	Sales			7,000
	Sold merchandise on account for $7,000, terms F.O.B. destination, and paid the freight bill of $400			

Buyer's entry:

5-11-X4	Purchases		7,000	
	Accounts Payable			7,000
	Purchased $7,000 of inventory, terms F.O.B. destination			

- If goods are sold F.O.B. shipping point, the purchaser is responsible for paying freight costs incurred in transporting the merchandise from the point of shipment to its destination. Freight cost incurred by a purchaser is called freight-in, and is added to purchases in calculating net purchases:

Seller's entry:

6-6-X4	Accounts Receivable		8,000	
	Sales			8,000
	Sold merchandise on account for $8,000, terms F.O.B. shipping point			

Buyer's entry:

6-6-X4	Purchases	8,000	
	Freight-in	1,500	
	Cash		1,500
	Accounts Payable		8,000
	Purchased $8,000 of inventory, terms F.O.B. shipping point, and paid the shipping freight bill of $1,500		

- If goods are sold F.O.B. Shipping point, freight prepaid, the seller prepays the trucking company as an accommodation to the purchaser. This prepaid freight increases the accounts receivable of the seller. That is, the seller expects payment for the merchandise and a reimbursement for the freight. The purchaser would record this transaction by debiting Purchases for the amount of the purchase, debiting Freight-In for the amount of the freight, and crediting Accounts Payable for the combined amount due to the seller.

Seller's entry:

3-10-X8	Accounts Receivable	10,400	
	Cash		400
	Sales		10,000
	Sold merchandise on account for $10,000, terms F.O.B. shipping point, $400 freight prepaid		

Buyer's entry:

3-10-X8	Purchases	10,000	
	Freight-in	400	
	Accounts Payable		10,400
	Purchased merchandise on account for $10,000, terms F.O.B. shipping point, $400 freight prepaid		

Importantly, cash discounts for prompt payment are not usually available on the freight charges. For example, if there was a 2% discount on the above purchase, it would amount to $200 ($10,000 X 2%), not $208 ($10,400 X 2%).

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2.9 The Calculation of Net Purchases

A number of new accounts have been introduced in this chapter. Purchases, Purchase Returns and Allowances, Purchase Discounts, and Freight-in have all been illustrated. Each of these accounts is necessary to to calculate the "net purchases" during a period.

Notice that the table at right reveals total purchases of $400,000 during the period. This would be based on the total invoice amount for all goods purchased during the period, as identified from the Purchases account in the ledger. The cost of the purchases is increased for the freight-in costs. Purchase discounts and purchase returns and allowances are subtracted. The result is that the "net purchases" are $420,000. Net purchases reflect the actual costs that were deemed to be ordinary and necessary to bring the goods to their location for resale to an end customer. Importantly, storage costs, insurance, interest and other similar costs are considered to be period costs that are not attached to the product. Instead, those ongoing costs are simply expensed in the period incurred as an operating expense of the business.

Add: Purchases		$400,000
Freight-in		40,000
		$440,000
Less: Purchase discounts	$ 6,000	
Purchase returns & allowances	14,000	20,000
Net purchases		$420,000

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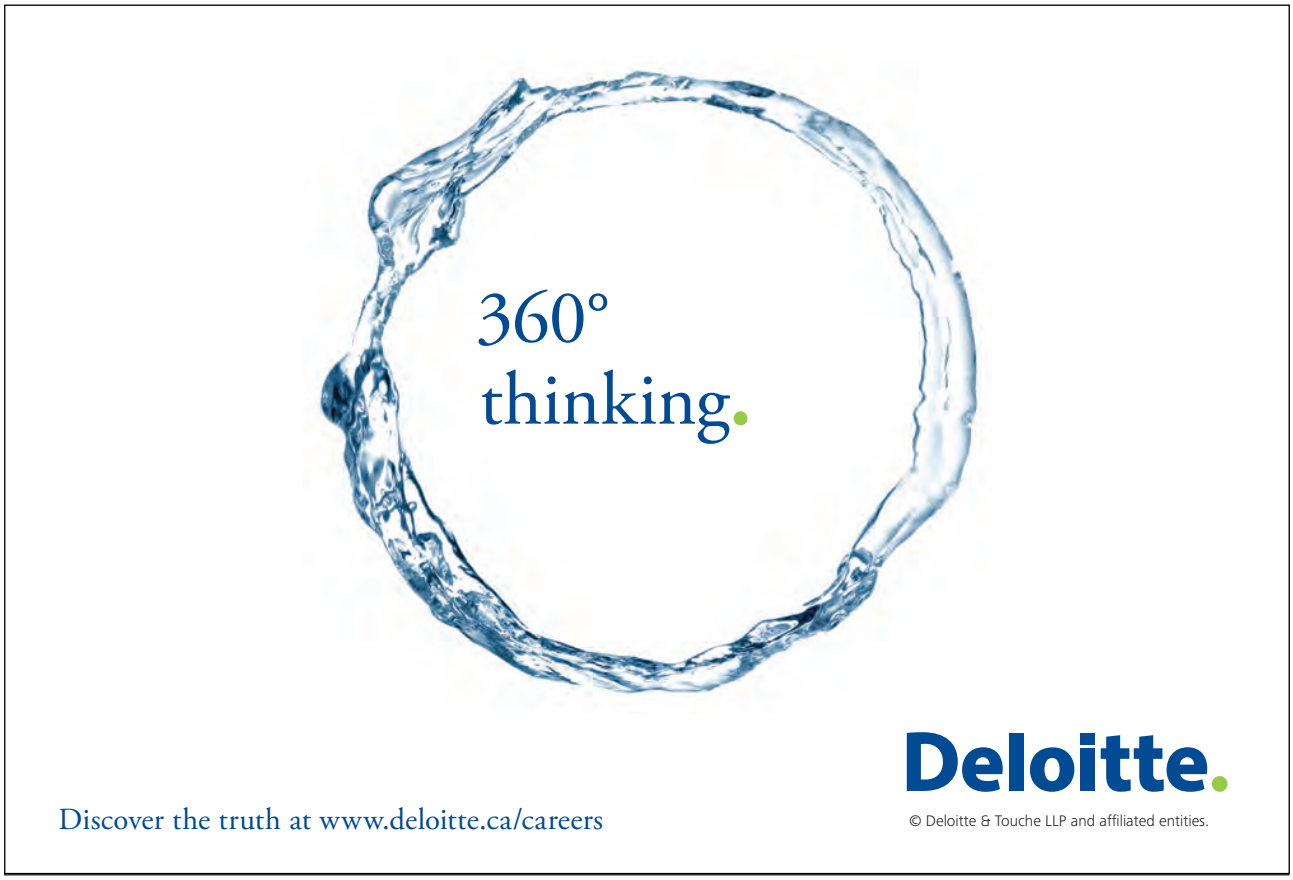

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2.10 Cost of Goods sold

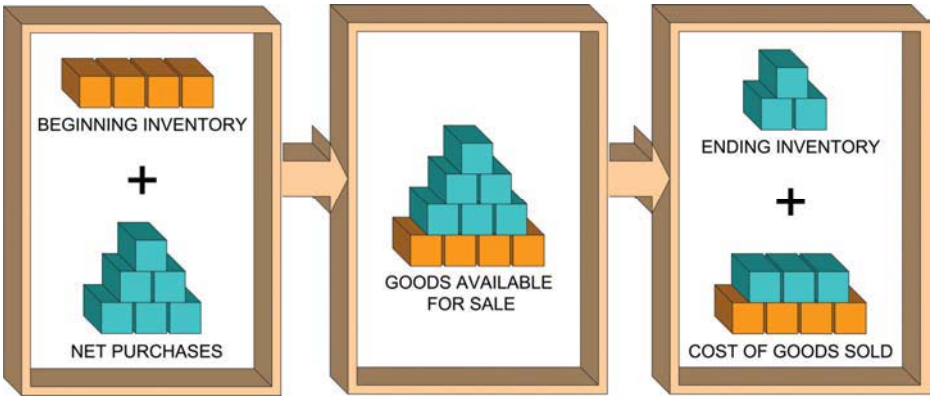
Early in this chapter, it was indicated that the cost of purchases must ultimately be allocated between cost of goods sold and inventory, depending on the portion of the purchased goods that have been resold to end customers. This allocation must also take into consideration any beginning inventory that was carried over from prior periods.

Beginning inventory, Jan. 1	$115,000	*From end of prior period*
Plus: Net purchases	420,000	*From calculations above*
Goods available for sale	$535,000	
Less: Ending inventory, Dec. 31	91,000	*From physical count*
Cost of goods sold	$444,000	

Very simply, goods that remain unsold at the end of an accounting period should not be "expensed" as cost of goods sold. Therefore, the calculation of cost of goods sold requires an assessment of total goods available for sale, from which ending inventory is subtracted.

With a periodic system, the ending inventory is determined by a physical count. In that process, the goods held are actually counted and assigned cost based on a consistent method. The actual methods for assigning cost to ending inventory is the subject of considerable discussion in the inventory chapter. For now, let's just take it as a given that the $91,000 shown represents the cost of ending inventory.

Understanding the allocation of costs to ending inventory and cost of goods sold is very important and is worthy of additional emphasis. Consider the following diagram:



The beginning inventory is equal to the prior year's ending inventory, as determined by reference to the prior year's ending balance sheet. The net purchases is extracted from this year's ledger (i.e., the balances of Purchases, Freight-in, Purchase Discounts, and Purchase Returns & Allowances). Goods available for sale is just the sum of beginning inventory and net purchases. Goods available for sale is not an account, per se; it is merely an abstract result from adding two amounts together. Now, the total cost incurred (cost of goods available for sale) must be "allocated" according to its nature at the end of the year -- if the goods are still held, those costs become an asset amount (inventory), and to the extent the goods are not still held, those costs are attributed to the cost of goods sold expense category.

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2.11 Detailed Income Statement for Merchandise Operation

Wow, what a lot of activity to consider -- net sales, net purchases, cost of sales, gross profit, etc.! How do you keep all this straight? A detailed income statement provides the necessary organization of data in an understandable format. Study the following detailed income statement for Bill's Sporting Goods.

As you do so, focus on the following points:

- Note the calculation of net sales
- Note the inclusion of the details about net purchases
- Note the cost of sales
- Note the gross profit amount
- Note that freight-out is reported in the expense section

BILL'S SPORTING GOODS
Detailed Income Statement
For the Year Ending December 31, 20X5

REVENUES				
Sales				$750,000
Less: Sales discounts			$ 7,000	
Sales returns & allowances			3,000	10,000
Net sales				$740,000
COST OF GOODS SOLD				
Beginning inventory, Jan. 1			$115,000	
Add: Purchases		$400,000		
Freight-in		40,000		
		$440,000		
Less: Purchase discounts	$ 6,000			
Purchase returns & allow.	14,000	20,000		
Net purchases			420,000	
Goods available for sale			$535,000	
Less: Ending inventory, Dec. 31			91,000	
Cost of goods sold				444,000
GROSS PROFIT				$296,000
EXPENSES				
Advertising			$ 60,000	
Freight-out			32,000	
Depreciation			18,000	
Utilities			29,000	
Salaries			134,000	
Rent			12,000	285,000
NET INCOME				$ 11,000

Sales		$750,000
Less: Sales discounts	$ 7,000	
Sales returns & allowances	3,000	10,000
Net sales		$740,000

Add: Purchases		$400,000
Freight-in		40,000
		$440,000
Less: Purchase discounts	$ 6,000	
Purchase ret. & allow.	14,000	20,000
Net purchases		$420,000

Beginning inventory, Jan. 1	$115,000
Net purchases	420,000
Goods available for sale	$535,000
Less: Ending inventory, Dec. 31	91,000
Cost of goods sold	$444,000

Net sales	$740,000
Cost of goods sold	444,000
Gross profit	$296,000

Be aware that the income statement you see for a merchandising company may not present all of this detail. Depending on the materiality of the individual lines items, it may be sufficient to only present line items for the key elements, like net sales, cost of sales, gross profit, various expense accounts, and net income.

2.12 Closing Entries

Because of all the new income statement related accounts that were introduced for the merchandising concern, it is helpful to revisit the closing process. Recall the importance of closing; to transfer the net income to retained earnings, and reset the income statement accounts to zero in preparation for the next accounting period. As a result, all income statement accounts with a credit balance must be debited and vice versa. The closing entries for Bill's Sporting Goods appear on the following page. Several items are highlighted in these journal entries, and are discussed further in the next paragraph.

These closing entries are a bit more complex than that from the earlier chapter. In particular, note that the closing includes all of the new accounts like purchases, discounts, etc. In addition, it is very important to update the inventory records. You may be confused to see inventory being debited and credited in the closing process. After all isn't inventory a balance sheet (real) account? And, don't we only close the temporary accounts? Why then is inventory included in the closing? The answer is that inventory must be updated to reflect the ending balance on hand. Remember that the periodic system resulted in a debit to purchases, not inventory. Further, as goods are sold, no entry is made to reduce inventory. Therefore, the Inventory account would continue to carry the beginning of year balance throughout the year. As a result, Inventory must be updated at the time of closing. The above following entries accomplish just that objective by crediting/removing the beginning balance and debiting/establishing the ending balance. If you study these entries carefully, you will note that they include causing the Income Summary account to be reduced by the cost of sales amount (beginning inventory + net purchases - ending inventory).

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12-31-X5	Sales		750,000	
	Purchase Discounts		6,000	
	Purchase Returns & Allowances		14,000	
	Inventory		91,000	
	Income Summary			861,000
	To close income statement accounts with a credit balance, and establish ending inventory balance			
12-31-X5	Income Summary		850,000	
	Sales Discounts			7,000
	Sales Returns & Allowances			3,000
	Purchases			400,000
	Freight-in			40,000
	Advertising Expense			60,000
	Freight-out			32,000
	Depreciation Expense			18,000
	Utilities Expense			29,000
	Salaries Expense			134,000
	Rent Expense			12,000
	Inventory			115,000
	To close income statement accounts with a debit balance, and remove the beginning inventory balance			
12-31-X5	Income Summary		11,000	
	Retained Earnings			11,000
	To close Income Summary to retained earnings (note that the balance is equal to the net income)			

3. Alternative Inventory System

Earlier in the chapter this was stated:

> "Now, there are two different techniques for recording the purchase -- depending on whether a periodic system or a perpetual system is in use. Generalizing, the periodic inventory system is easier to implement but is less robust than the "real-time" tracking available under a perpetual system. Conversely, the perpetual inventory system involves more "systemization" but is a far superior business management tool."

The periodic system only required the recording of inventory purchases to a Purchases account; inventory records were updated only during the closing process based on the results of a physical count. No attempt is made to adjust inventory records concurrent with actual purchase and sale transactions. The weakness of the periodic system is that it provides no real-time data about the levels of inventory or gross profit data. If inventory is significant, the lack of up-to-date inventory data can be very costly. Managers need to know what is selling, and what is not selling, in order to optimize business success. That is why many successful merchants use sophisticated computer systems to implement perpetual inventory management. You have no doubt noted bar code scanners at a checkout for quickly pricing goods, but did you know that the business's inventory records may also be updated as the item is being scanned? With a high-performance perpetual system, each purchase or sale results in an immediate update of the inventory and cost of sales data in the accounting system. The following entries are appropriate to record the purchase and subsequent resale of an inventory item:

Entry to record purchase of inventory:

12-12-X1	Inventory	3,000	
	Accounts Payable		3,000
	Purchased $3,000 of inventory on account		

Entries to record sale of inventory:

12-21-X1	Accounts Receivable	5,000	
	Sales		5,000
	Sold merchandise on account		
12-21-X1	Cost of Goods Sold	3,000	
	Inventory		3,000
	To record the cost of merchandise sold		

With the perpetual system, the Purchases account is not needed. The Inventory account and Cost of Goods Sold account are constantly being adjusted as transactions occur. Freight-in is added to the Inventory account. Discounts and returns reduce the Inventory account. Therefore, the determination of cost of goods sold is determined by reference to the account's general ledger balance, rather than needing to resort to the calculations illustrated for the periodic system.

If you think the perpetual system looks easier, don't be deceived. Consider that it is no easy task to determine the cost of each item of inventory as it is sold, and that is required for a proper application of the perpetual system. In a large retail environment, that is almost impossible without a sophisticated computer system. Nevertheless, such systems have become commonplace. This has come about with the decline in the cost of computers, along with a growth in "chain stores" that can apply the same technology to many individual stores.

One final point should be noted. A physical count of goods, where employees take to the store and count every item on hand, is still needed with a perpetual system. No matter how good the computer system, differences between the computer record and physical quantity on hand will arise. Differences are created by theft, spoilage, waste, errors, and so forth. Therefore, merchants must occasionally undertake a physical count, and adjust the Inventory accounts to reflect what is actually on hand.

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4. Income Statement Enhancements

The expanded income statement for Bill's Sporting Goods was presented above. Yet, there are even more issues that can influence the form and shape of the income statement.

In the illustration for Bill's Sporting Goods, the operating expenses were all reported together. Often, companies will wish to further divide the expense items according to their nature: selling expenses (those associated with the sale of merchandise) or general and administrative (costs incurred in the management of the business). Some costs must be allocated between the two categories; like depreciation of the corporate headquarters wherein both sales and administrative activities are conducted.

A business may, from time to time, have incidental or peripheral transactions that contribute to income. For example, a business might sell land at a gain. Or, a fire might produce a loss. These gains and losses are often reported separate and apart from the measures of revenues and expenses associated with central ongoing operations.

Likewise, many businesses break out the financing costs (i.e., interest expense) from the other expense components. This tends to separate the operating impacts from the cost of capital needed to produce those operating results. This is not to suggest that interest is not a real cost. Instead, the company has made decisions about borrowing money ("leverage"), and breaking out the interest cost separately allows users to have a better handle on how well the borrowing decisions are working -- investors want to know if enough extra income is being produced to cover the added financing costs associated with growing via debt financing.

Not to be overlooked in the determination of income is the amount of any tax that must be paid. Businesses are subject to many taxes, not the least of which is income tax. Income tax must be paid, and is usually based on complex formulas related to the amount of businesses income. As a result, it is customary to present income before tax, then the amount of tax, and finally the net income.

The income statement below illustrates the added concepts via a multiple-step income statement. A multiple-step approach divides the businesses operating results into separate categories or steps, and simplifies the financial statement user's ability to understand the intricacy of an entity's operations. This illustration is fairly elaborate, but you also need to know that income reporting can become even more involved. In a subsequent chapter, you will learn about additional special reporting for other unique situations, like discontinued operations, extraordinary events, and so forth.

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HUNTER COMPANY
Income Statement
For the Year Ending December 31, 20X9

REVENUES				
Sales				$660,000
Less: Sales discounts			$ 5,000	
Sales returns & allowances			2,000	7,000
Net sales				$653,000
COST OF GOODS SOLD				
Beginning inventory, Jan. 1			$120,000	
Add: Purchases		$230,000		
Freight-in		10,000		
		$240,000		
Less: Purchase discounts	$ 2,400			
Purchase returns & allowances	3,600	6,000		
Net purchases			234,000	
Goods available for sale			$354,000	
Less: Ending inventory, Dec. 31			71,000	
Cost of goods sold				283,000
GROSS PROFIT				$370,000
SELLING EXPENSES				
Advertising		$ 70,000		
Freight-out		4,000		
Depreciation		28,000		
Utilities		11,000		
Salaries		29,000	$142,000	
GENERAL & ADMINISTRATIVE				
Salaries		$ 63,000		
Depreciation		17,000		
Utilities		22,000		
Insurance		44,000		
Rent		24,000	170,000	
OTHER				
Loss on sale of land		$ 2,000		
Interest expense		7,000	9,000	321,000
INCOME BEFORE TAX				$ 49,000
Income tax expense				10,000
NET INCOME				$ 39,000

Accountants must always be cognizant of the capacity of the financial statement user to review and absorb the reports. Sometimes, the accountant may decide that a simplified presentation is more useful. In those cases, the income statement may be presented in a "single-step" format. This very simple approach reports all revenues (and gains) together, and the aggregated expenses (and losses) are tallied and subtracted to arrive at income. The single-step income statement for Hunter is shown below:

HUNTER COMPANY **Income Statement** **For the Year Ending December 31, 20X9**		
REVENUES		
Net sales		$653,000
EXPENSES AND LOSSES		
Cost of goods sold	$283,000	
Selling expenses	142,000	
General & administrative	170,000	
Loss on sale of land	2,000	
Interest expense	7,000	604,000
INCOME BEFORE TAX		$ 49,000
Income tax expense		10,000
NET INCOME		$ 39,000

Caution should be used when examining a single-step presentation. One should look at more than the bottom-line net income, and be certain to discern the components that make up income. For example, a company's core operations could be very weak, but the income could be good because of a non-recurring gain from the sale of assets. Tearing away such "masking" effects are a strong argument in favor of the more complex multiple-step approach.

4.1 Analysis of a Detailed Income Statement

No matter which income statement format is used, all the detail in the world is of no value if it is not carefully evaluated. One should monitor not only absolute dollar amounts, but should also pay close attention to ratios and percentages. It is typical to monitor the gross profit margin and the net profit on sales:

Gross Profit Margin = Gross Profit/Net Sales
$370,000/$653,000 = 56.66% for Hunter

Net Profit on Sales = Net Income/Net Sales
$39,000/$653,000 = 5.97% for Hunter

There are countless variations of these calculations, but they all go to the same issue – evaluating trends in performance unrelated to absolute dollar amounts.

You should also be aware that margins can be tricky. For example, suppose Liu's Janitorial Supply sold plastic trash cans. During Year 1, sales of cans were $3,000,000, and these units cost $2,700,000. During Year 2, oil prices dropped significantly. Oil is a critical component in plastics, and Liu passed along cost savings to his customers. Liu's Year 2 sales were $1,000,000, and the cost of goods sold was $700,000. Liu was very disappointed in the sales drop. However, he should not despair, as his gross profit was $300,000 in each year, and the gross profit margin soared during Year 2. The gross profit margin in Year 1 was 10% ($300,000/$3,000,000), and the gross profit margin in Year 2 was 30% ($300,000/$1,000,000). Despite the plunge in sales, Liu may actually be better off. Although this is a dramatic example to make the point, even the slightest shift in business circumstances can change the relative relationships between revenues and costs. A smart manager or investor will always keep a keen eye on business trends revealed by the shifting of gross profit and net profit percentages over time.

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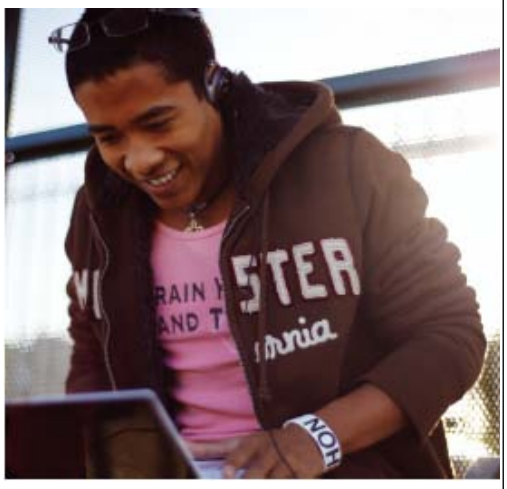

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5. The Control Structure

An organization should carefully define various measures to safeguard its assets, check the reliability and accuracy of accounting information, ensure compliance with management policies, and evaluate operating performance and efficiency. The internal control structure depends on the accounting system, the control environment, and the control procedures. The control environment is the combined effect of a firm's policies and attitudes toward control implementation. Control procedures are specifically integrated into the accounting system and relate to the following features:

- One important control is limited access to assets. This control feature assures that only authorized and responsible employees can obtain access to key assets. For example, a supplies stock area may be accessible only to department supervisors.

- Separation of duties is another important control. Activities like transaction authorization, transaction recording, and asset custody should be performed by different employees. Separating functions reduces the possibility of errors (because of cross-checking of accounting records to assets on hand, etc.) and fraud (because of the increased need for collusion among employees).

- A number of accountability procedures can be implemented to improve the degree of internal control:

    - Duty authorization is a control feature which requires that certain functions be performed by a specific person (e.g., customer returns of merchandise for credit can be approved only by a sales manager).

    - Prenumbered documents allow ready identification of missing items. For example, checks are usually prenumbered so that missing checks can be identified rapidly.

    - Independent verification of records is another control procedure. Examples include comparing cash in a point of sale terminal with the sales recorded on that register and periodic reconciliation of bank accounts.

- A company may engage an accounting firm or CPA to provide an independent review of the company's accounting records and internal controls. The accountant may offer suggestions for improvement and test the established system to determine if it is functioning as planned.

In designing and implementing an internal control system, careful attention should be paid to the costs and benefits of the system. It is folly to develop a system which costs more to establish and maintain than it is worth to the company.

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5.1 Internal Control in the Merchandising Environment

The basic elements of control are common to most businesses. However, the merchandiser must pay special attention to several unique considerations. Foremost is asset control. Obviously, the retailer has a huge investment in inventory, and that inventory is not easily "isolated." As a result, theft and spoilage are all too common. Retailers should go to great lengths to protect against these costly events. Let's think, for a moment, about walking through an electronics retail store. Upon entering the front door, you may first notice "architecturally pleasing" barricades (like planter boxes or posts) to prevent crash entry. Next you may be greeted by a doorman (guard), who perhaps oversees separate entrances and exists, and is responsible for matching receipts to goods leaving the store. Of course, there is the ever-present sensor that will lock down the exit if a hidden sensor has not been deactivated at check out. And, a quick glance up reveals that you are on "candid" camera! As you stroll the store, you may note that the most expensive items are display only; to get the one you want to buy, you present a claim ticket at a caged area. Only authorized employees can enter that area. At check out, point-of-sale terminals must be accessed with a key that is assigned to an employee. The terminal knows who checked-out the sale. In addition, an employee may look inside the box that contains the item you are buying, compare you to your picture ID, and so forth. In general, the goal is simple -- make sure that only purchased merchandise gets out of the store. Several times daily, the cash drawers in the terminals will be pulled (replaced with another) and their contents audited. Daily bank runs (maybe via armored courier) will occur to make sure that funds are quickly and safely deposited in the bank. These controls are what you see on the "front end" of the business. Behind the scenes, a lot more is going on. Next, we will contemplate the purchasing cycle controls.

5.2 Internal Control and the Purchasing Cycle

Purchasing cycle controls are invisible to the customer, but every much as important. And, these purchasing controls are pervasive in other non-merchandising businesses as well. There is no single, correct process, but the following concepts should be considered:

- Purchases should be initiated only by appropriate supervisory personnel, in accord with budgets or other authorizing plans.

- The purchasing action should be undertaken by trained purchasing personnel who know how to negotiate the best terms (with full understanding of freight issues, discount issues, and so forth).

- Purchasing departments should have strong procedural rules, including prohibitions against employees receiving "gifts," limitations on dealings with related parties, and obtaining multiple bids.

- A purchase order should be prepared to initiate the actual order.

- When goods are received, the receiving department should not accept them without inspection, including matching the goods to an open purchase order to make sure that what is being delivered was in fact ordered.

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- The receiving department should prepare a receiving report, indicating that goods have been received in good order.

- When an invoice ("bill") is received, it should be carefully matched to the original purchase order and receiving report. The bill should be scheduled for payment in time to take advantage of available discounts. It is important to only pay for goods that were ordered and received. In a large organization, the person preparing the check to pay the invoice has likely never seen the goods; hence the importance of complete documentation.

- Before payment is released, an independent supervisor should make one last review of all the documents -- the purchase order, the receiving report, and the check.

5.3 Generalizing About Control

At this point in your study, most of your thought process has been directed toward procedural elements. These aspects must be understood, of course, but accounting is so much more involved than that. Accountants spend much of their time dealing with issues that are complex, like designing and testing the control environment! For example, an auditor does not just look at a bunch of transactions to see if the debits and credits are correct. Instead, they will carefully study the control environment and test to see if it is working as planned. If it is, then the "system" should be producing correct financial data, and much less time can be devoted to actually focusing on specific transactions.

There are control elements associated with virtually every accounting issue, and those will become ever more apparent as you move forward in your study of accounting. The next series of chapters delve into specific topical areas, following the normal balance sheet line up -- cash and highly liquid investments, receivables, inventories, and so forth. Those discussions focus less on debits and credits, and more on the business side of accounting.

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Part 2
Cash and Highly-Liquid Investments

Your goals for this "cash and highly-liquid investments" chapter are to learn about:

- The composition of cash and how cash is presented on the balance sheet.
- Cash management and controls for receipts and disbursements.
- Reconciliation of bank accounts.
- The correct operation of a petty cash system.
- Accounting for highly-liquid investments known as "trading securities."

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6. Cash Composition

Given its liquid and vital status, cash is typically listed first within the current asset section of the balance sheet. But what exactly is cash? This may seem like a foolish question until one considers the possibilities. Obviously, cash includes coins and currency. But what about items like money on deposit in bank accounts, un deposited checks from customers, certificates of deposit, and similar items? Some of these are deemed to be cash and some are not. What rule shall be followed? Generalizing, cash includes those items that are acceptable to a bank for deposit and are free from restrictions (i.e., available for use in satisfying current debts). Cash typically includes coins, currency, funds on deposit with a bank, checks, and money orders. Items like postdated checks, certificates of deposit, IOUs, stamps, and travel advances are typically not classified as cash. The existence of compensating balances (amounts that must be left on deposit and cannot be withdrawn) should be disclosed; if such amounts are very significant, they are reported separately from cash. Also receiving separate treatment are "sinking funds" (monies that must be set aside to satisfy debts) and heavily restricted foreign currency holdings (that cannot easily be converted into dollars). These unique categories of funds may be reported in the long-term investments category.

6.1 Cash Equivalents

In lieu of reporting "cash," some companies will report "cash and cash equivalents." Cash equivalents arise when companies place their cash in very short-term interest-earning financial instruments that are deemed to be highly secure and will convert back into cash within 90 days. Many short-term government-issued securities (e.g., treasury bills) meet these conditions. In addition, active markets exist for such securities, and these financial instruments are usually very marketable in the event the company needs access to funds in advance of maturity. Cash management strategies dictate that large amounts of cash not be held in "unproductive" accounts that do not generate interest income. As a result, surplus cash is often invested in these instruments. Because of their unique nature, they are considered to be cash equivalents, and are often reported with cash on the balance sheet. Following is an excerpt from a recent balance sheet of the automotive division of General Motors Corporation. You will note that the company held over $15 billion in cash:

Cash and cash equivalents (Note 1) $ 15,187

Note 1 to the financial statements included this additional commentary about cash:

> Cash and Cash Equivalents
>
> > Cash equivalents are defined as short-term, highly-liquid investments with original maturities of 90 days or less.

7. Cash Management

It is very important to ensure that sufficient cash is available to meet obligations and to make sure that idle cash is appropriately invested to maximize the return to the company. One function of the company "treasurer" is to examine the cash flows of the business, and pinpoint anticipated periods of excess or deficit cash flows. A detailed cash budget is often maintained and updated on a regular basis. The cash budget is a major component of a cash planning system and represents the overall plan of activity that depicts cash inflows and outflows for a stated period of time. A future chapter provides an in-depth look at cash budgeting.

You may tend to associate cash shortages as a sign of weakness, and, indeed, that may be true. However, such is not always the case. A very successful company with a great product or service may be rapidly expanding via new business locations, added inventory levels, growing receivables, and so forth. All of these events give rise to the need for cash and can create a real crunch even though the business is fundamentally prospering. To sustain the growth, careful planning must occur.

7.1 Strategies to Enhance Cash Flows

As a business looks to improve cash management or add to the available cash supply, a number of options are available. Some of these solutions are "external" and some are "internal" in nature. External solutions include:

Issuing additional shares of stock -- This solution has a definite advantage, because it allows the company to obtain cash, without a fixed obligation to repay. As a result, this may seem like a sure-fire costless option. Unfortunately, the existing shareholders do incur a very real detriment, because the added share count dilutes their ownership proportions. In essence, it is akin to existing shareholders selling off part of the business; a solution that may be seen as a last resort if the future is bright.

Borrowing additional funds -- This solution brings no additional shareholders to the table, but borrowed funds must be repaid along with interest. Thus, the business cost and risk is increased. On a related note, many companies will establish a standing line of credit that enables them to borrow as needed, and not borrow at all if funds are not needed. This solution provides a ready source of liquidity, without actually increasing debt levels. Banks typically provide such lines of credit in exchange for a fee based on the amount of the line of credit.

The company may look within its own operating structure to find internal cash flow enhancements:

Accelerate cash collections -- If a company can move its customer base to pay more quickly, a significant source of cash is found! Simple tools include electronic payment, credit cards, lockbox systems (i.e., the establishment of bank depositories near to the customer for quick access to funds/thereby avoiding mail and clearing delays), and cash discounts for prompt payment.

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Postponement of cash outflows -- Companies may “drag their feet” on cash outflows, delaying payment as long as possible. In addition, paying via check sent through the mail allows use of the “float” to preserve cash on hand. However, you need to know that it is illegal to issue a check when there are insufficient funds in the bank to cover that item (even if you know a deposit is forthcoming that will cover the check). Some companies make travel advances to employees for anticipated costs to be incurred on an upcoming trip; it is better for cash flow to have the employee incur the cost (perhaps on a credit card) and then submit receipts for reimbursement.

Cash control -- Systems and procedures should be adopted to safeguard an organization’s funds. Internal control for cash is based on the same general control features introduced in the previous chapter; access to cash should be limited to a few authorized personnel, incompatible duties should be separated, and accountability features (like prenumbered checks, etc.) should be developed.

- The control of receipts from cash sales should begin at the point of sale and continue through to deposit at the bank. Specifically, cash registers (or other point-of-sale terminals) should be used, actual cash on hand at the end of the day should be compared to register tapes, and daily bank deposits should be made. Any cash shortages or excesses should be identified and recorded in a Cash Short & Over account.

- Control of receipts from customers on account begins when payments are received (in the mail or otherwise). The person opening the mail should prepare a listing of checks received and forward the list to the accounting department. The checks are forwarded to a cashier who prepares a daily bank deposit. The accounting department enters the information from the listing of checks into the accounting records and compares the listing to a copy of the deposit slip prepared by the cashier.

- The controls over cash disbursements include procedures that allow only authorized payments for actual expenditures and maintenance of proper separation of duties. Control features include requiring that significant disbursements be made by check, performance of periodic bank reconciliations, proper utilization of petty cash systems, and verification of supporting documentation before disbursing funds.

The bank reconciliation and petty cash systems referred to above have specific accounting implications to consider, and are the subject of the following sections of this chapter.

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8. Blank Reconciliation

One of the most common cash control procedures, and one which you may already be performing on your own checking account, is the bank reconciliation. In business, every bank statement should be promptly reconciled by a person not otherwise involved in the cash receipts and disbursements functions. The reconciliation is needed to identify errors, irregularities, and adjustments for the Cash account. Having an independent person prepare the reconciliation helps establish separation of duties and deters fraud by requiring collusion for unauthorized actions.

There are many different formats for the reconciliation process, but they all accomplish the same objective. The reconciliation compares the amount of cash shown on the monthly bank statement (the document received from a bank which summarizes deposits and other credits, and checks and other debits) with the amount of cash reported in the general ledger. These two balances will frequently differ. Differences are caused by items reflected on company records but not yet recorded by the bank; examples include deposits in transit (a receipt entered on company records but not processed by the bank) and outstanding checks (checks written which have not cleared the bank). Other differences relate to items noted on the bank statement but not recorded by the company; examples include nonsufficient funds (NSF) checks ("hot" checks previously deposited but which have been returned for nonpayment), bank service charges, notes receivable (like an account receivable, but more "formalized") collected by the bank on behalf of a company, and interest earnings.

The following format is typical of one used in the reconciliation process. Note that the balance per the bank statement is reconciled to the "correct" amount of cash; likewise, the balance per company records is reconciled to the "correct" amount. These amounts must agree. Once the correct adjusted cash balance is satisfactorily calculated, journal entries must be prepared for all items identified in the reconciliation of the ending balance per company records to the correct cash balance. These entries serve to record the transactions and events which impact cash but have not been previously journalized (e.g., NSF checks, bank service charges, interest income, and so on).

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THIS STATEMENT COVERS:

July 1, 20X3 through July 31, 20X3

STATEMENT FOR:

The Tackle Shack
445 Main Street
Lake City

CHECKING ACCOUNT #	MONTHLY SUMMARY		
76-7888-0987	Previous statement balance on 6-30-X3	46,543.89	
	Total of 4 deposits for	31,209.11	+
	Total of 16 withdrawals for	27,077.77	-
	Interest earnings for	119.34	+
	Service charges for	55.00	-
	New balance	50,739.57	

CHECKS AND	CHECK	DATE PAID		CHECK	DATE PAID	
	5454	2-Jul	4,456.09	*5465*	16-Jul	85.58
	5457	3-Jul	245.00	5466	19-Jul	1199.19
	5458	3-Jul	12.34	5467	23-Jul	76.14
	5459	10-Jul	66.14	5468	23-Jul	375.62
	5460	5-Jul	11,998.20	5469	30-Jul	2779.59
	5461	9-Jul	3,000.00	5470	27-Jul	9.31
	5463	16-Jul	2,119.44	*5472*	31-Jul	109.00
	Electronic funds tranfer				11-Jul	109.07
	NSF returned check				17-Jul	437.06
	NSF fee				31-Jul	25.00
	Monthly service fee				31-Jul	30.00

DEPOSITS AND	DATE	
Customer deposit at main location	10-Jul	12994.36
Customer deposit at river branch location	17-Jul	8855.10
Collection item -- note receivable	25-Jul	5,450.00
Credit card posting - transaction 07e79849657	25-Jul	3,909.65
Interest earnings	31-Jul	119.34

ACCOUNT: Cash

Date	Description	Debit	Credit	Balance
July 24, 20X3	Journal page 7	$ 9.31		$ 41,445.02
July 25, 20X3	Journal page 7		$ 3,909.65	45,355.36
July 25, 20X3	Journal page 7	30.30		45,325.06
July 25, 20X3	Journal page 7	109.00		45,216.06
July 30, 20X3	Journal page 7	1,196.69		44,019.37
July 30, 20X3	Journal page 8	50.00		43,969.37
July 31, 20X3	Journal page 8		3,565.93	47,535.30

WILL

Ending balance per bank statement	$XX,XXX
Add: Deposits in transit (and similar receipts entered on company records but not yet reported on the bank statement)	X,XXX
Deduct: Outstanding checks (and similar disbursements entered on company records but not reported on the bank statement)	X,XXX
Correct cash balance	$XX,XXX

Ending balance per company records	$XX,XXX
Add: Interest (and similar receipts reported on the bank statement but not entered on company records)	X,XXX
Deduct: NSF checks (and similar disbursements reported on the bank statement but not entered on company records)	X,XXX
Correct cash balance	$XX,XXX

WILL

8.1 Comprehensive Illustration of Bank Reconciliation

The following illustration provides a detailed example of a bank statement, additional data, the reconciliation process, and the corresponding journal entries. Conducting a bank reconciliation requires careful attention to the slightest of details. Even the smallest error will lead to frustration in trying to bring closure to the reconciliation effort.

THIS STATEMENT COVERS:	STATEMENT FOR:
July 1, 20X3 through July 31, 20X3	The Tackle Shack 445 Main Street Lake City

CHECKING ACCOUNT #	MONTHLY SUMMARY		
76-7888-0987	Previous statement balance on 6-30-X3	46,543.89	
	Total of 4 deposits for	31,209.11	+
	Total of 16 withdrawals for	27,077.77	–
	Interest earnings for	119.34	+
	Service charges for	55.00	–
	New balance	50,739.57	

CHECKS AND OTHER DEBITS	CHECK	DATE PAID		CHECK	DATE PAID	
	5454	2-Jul	4,456.09	*5465*	16-Jul	85.58
	5457	3-Jul	245.00	5466	19-Jul	1199.19
	5458	3-Jul	12.34	5467	23-Jul	76.14
	5459	10-Jul	66.14	5468	23-Jul	375.62
	5460	5-Jul	11,998.20	5469	30-Jul	2779.59
	5461	9-Jul	3,000.00	5470	27-Jul	9.31
	5463	16-Jul	2,119.44	*5472*	31-Jul	109.00
	Electronic funds tranfer				11-Jul	109.07
	NSF returned check				17-Jul	437.06
	NSF fee				31-Jul	25.00
	Monthly service fee				31-Jul	30.00

DEPOSITS AND OTHER CREDITS		DATE	
	Customer deposit at main location	10-Jul	12994.36
	Customer deposit at river branch location	17-Jul	8855.10
	Collection item -- note receivable	25-Jul	5,450.00

Additional Data

The preceding bank statement is for The Tackle Shop for July of 20X3. The following additional data is needed to reconcile the account:

- The first check listed on the previous page, #5454, was written in June but did not clear the bank until July 2.
- There were no other outstanding checks, and no deposits in transit at the end of June.
- The EFT (electronic funds transfer) on July 11 relates to the monthly utility bill; The Tackle Shop has authorized the utility to draft their account directly each month.
- The Tackle Shop is optimistic that they will recover the full amount, including the service charge, on the NSF check ("hot check") that was given to them by a customer during the month.
- The bank collected a $5,000 note for The Tackle Shop, plus 9% interest ($5,450).
- The Tackle Shop's credit card clearing company remitted funds on July 25; the Tackle Shop received an email notification of this posting and simultaneously journalized this cash receipt in the accounting records.
- The Tackle Shop made the 2 deposits listed on the previous page, and an additional deposit of $3,565.93 late in the afternoon on July 31, 20X3.
- The ending cash balance, per the company general ledger, was $47,535.30.
- The following check register is maintained by The Tackle Shop, and it corresponds to the amounts within the Cash account in the general ledger:

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DATE	PARTY	REF #	CHECK	DEPOSIT	Balance
1-Jul		Balance			$42,087.80
1-Jul	Bailey	5457	$ 245.00		41,842.80
2-Jul	Boyatzis	5458	12.34		41,830.46
3-Jul	Smith	5459	66.14		41,764.32
5-Jul	Blaize	5460	11,998.20		29,766.12
8-Jul	Paronto	5461	3,000.00		26,766.12
8-Jul	Void	5462			26,766.12
9-Jul	Deposit			$12,994.36	39,760.48
15-Jul	Sanchez	5463	2,119.44		37,641.04
15-Jul	Bauer	5464	525.00		37,116.04
15-Jul	Cameron	5465	85.58		37,030.46
17-Jul	Deposit			8,855.10	45,885.56
19-Jul	Hartman	5466	1,199.19		44,686.37
21-Jul	Ashkanasy	5467	76.14		44,610.23
22-Jul	Forest	5468	375.62		44,234.61
24-Jul	Augier	5469	2,779.59		41,455.02
24-Jul	Arbaugh	5470	9.31		41,445.71
25-Jul	Credit Card			3,909.65	45,355.36
25-Jul	Bento	5471	30.30		45,325.06
30-Jul	Peterson	5472	109.00		45,216.06
30-Jul	Taggart	5473	1,196.69		44,019.37
30-Jul	Klimoski	5474	50.00		43,969.37
31-Jul	Deposit			3,565.93	47,535.30
			$23,877.54	$29,325.04	

Bank Reconcinilation

The bank reconciliation for July is determined by reference to the preceding bank statement and other data. You must carefully study all of the data to identify deposits in transit, outstanding checks, and so forth. Be advised that tracking down all of the reconciling items can be a rather tedious, sometimes frustrating, task. Modern bank statements facilitate this process by providing sorted lists with asterisks beside the check numbers that appear to have gaps in their sequence numbering. Below is the reconciliation of the balance per bank statement to the correct cash balance. You should try to identify each item in this reconciliation within the previously presented data. If you need help, you might wish to refer to the companion website for a link to a line drawing that helps you find the necessary elements.

	A	B	C	D
2		**Ending balance per bank statement**		$ 50,739.57
3				
4				
5		**Add:** Deposits in transit		3,565.93
6				
7				
8		**Deduct:** Outstanding checks		
9		#5464	$ 525.00	
10		#5471	30.30	
11		#5473	1,196.69	
12		#5474	50.00	(1,801.99)
13				
14				
15		**Correct cash balance**		$ 52,503.51

The reconciliation of the balance per company records to the correct cash balance is presented below. This reconciliation will trigger various adjustments to the Cash account in the company ledger. If you need a little help finding the noted items, check the link provided on the companion website. The identified items caused cash to increase by $4,968.21 ($52,503.51 correct balance, less the balance on the company records of $47,535.30). Most of these amounts are fairly intuitive, except for the $462.06 debit to Accounts Receivable -- which indicates that The Tackle Shop is going to attempt to collect on the NSF check and related charge. The interest income of $569.34 reflects that posted by the bank ($119.34) plus the $450 on the collected note.

	B	C	D
16			
17	**Ending balance per company records**		$ 47,535.30
18			
19			
20	**Add:** Customer note collection	$ 5,450.00	
21	Interest earnings	119.34	5,569.34
22			
23	**Deduct:**		
24	EFT for utilities	$ 109.07	
25	NSF check returned	437.06	
26	NSF fee	25.00	
27	Service charges	30.00	(601.13)
28			
29			
30	**Correct cash balance**		$ 52,503.51

7-31-X3	Cash	4,968.21	
	Utilities Expense	109.07	
	Accounts Receivable	462.06	
	Miscellaneous Expense	30.00	
	Notes Receivable		5,000.00
	Interest Income		569.34
	To record adjustments necessitated by bank reconciliation		

8.2 Proof of Cash

Many a business prepares a reconciliation just like that illustrated. But, you should note that it leaves one gaping hole in the control process. What if you learned that the bank statement included a $5,000 check to an employee near the beginning of the month, and a $5,000 deposit by that employee near the end of the month (and these amounts were not recorded on the company records)? In other words, the employee took out an unauthorized “loan” for a while. The reconciliation would not reveal this unauthorized activity because the ending balances are correct and in agreement. To overcome this deficiency, some companies will reconcile not only the beginning and ending balances, but also the total checks per the bank statement to the total disbursements per the company records, and the total deposits per the bank statement to the total receipts on the company accounts. If a problem exists, the totals on the bank statement will exceed the totals per the company records for both receipts and disbursements. This added reconciliation

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technique is termed a proof of cash. It is highly recommended where the volume of transactions and amount of money involved is very large. Such unauthorized "borrowing" not only steals company interest income, but it also presents a risk of loss if the company funds are not replaced. Make no mistake, such schemes are highly illegal!

Also illegal is "kiting." Kiting occurs when one opens numerous bank accounts at various locations and then proceeds to write checks on one account and deposit them to another. In turn, checks are written on that account, and deposited to yet another bank. And, over and over and over. In time, each of the bank accounts may appear to have money, but it is illusionary, because there are numerous checks "floating" about that will hit and reduce the accounts. Somewhere in the process of running this scam, the crook makes off with a cash withdrawal (or writes a check that appears to be good to an unsuspecting merchant) and skips town. That is why you will often see bank notices that deposited funds cannot be withdrawn for several days; they have been burned once too often, and want to be sure that a deposit clears the bank on which it is drawn before releasing those funds. Now, the point of this discussion is not to give you any ideas -- but to alert you to be careful in your dealings with others. Kiting is complex and illegal, and many a person is "doing time" in jail for such dealings. Enhanced electronic clearing procedures adopted by banks in recent years have made kiting far more difficult to accomplish.

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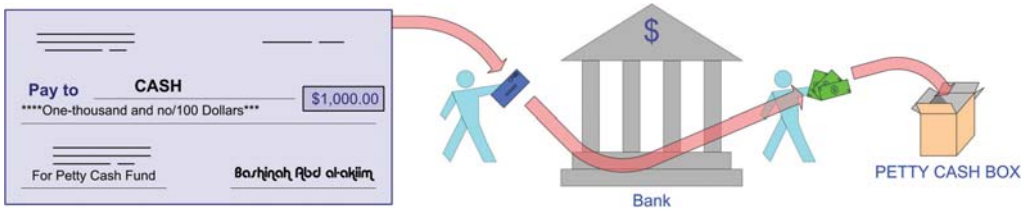
9. Petty Cash

Petty cash, also known as imprest cash, is a fund established for making small payments that are impractical to pay by check. Examples include postage due, reimbursement to employees for small purchases of office supplies, and numerous similar items. The establishment of a petty cash system begins by making out a check to cash, cashing it, and placing the cash in a petty cash box:



A petty cash custodian should be designated to have responsibility for safeguarding and making payments from this fund. At the time the fund is established, the following journal entry is needed. This journal entry, in essence, subdivides the petty cash portion of available funds into a separate account.

1-31-X4	Petty Cash	1,000	
	Cash		1,000
	To establish a $1,000 petty cash fund		

Policies should be established regarding appropriate expenditures (type and amount) that can be paid from petty cash. When a disbursement is made from the fund by the custodian, a receipt should always be placed in the petty cash box. The receipt should clearly set forth the amount and nature of expenditure. The receipts are sometimes known as petty cash vouchers. Therefore, at any point in time, the receipts plus the remaining cash should equal the balance of the petty cash fund (i.e., the amount of cash originally placed in the fund and recorded by the entry above).

9.1 Replenishment of Petty Cash

As expenditures occur, cash in the box will be depleted. Eventually the fund will require replenishment back to its original level. To replenish the fund, a check for cash is prepared in an amount to bring the fund back up to the desired balance. The check is cashed and the proceeds are placed in the petty cash box. At the same time, receipts are removed from the petty cash box and formally recorded as expenses.

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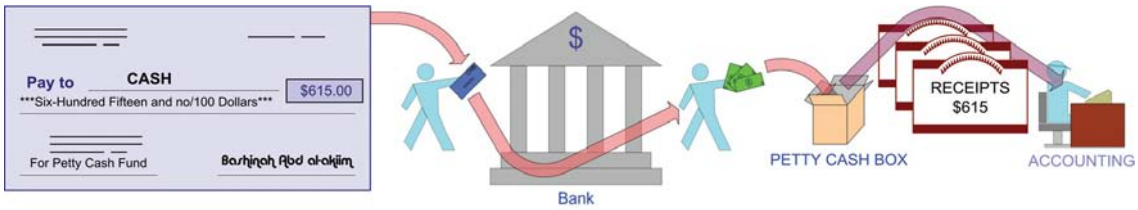

The journal entry for this action involves debits to appropriate expense accounts as represented by the receipts, and a credit to Cash for the amount of the replenishment. Notice that the Petty Cash account is not impacted -- it was originally established as a base amount and its balance has not been changed by virtue of this activity.

2-28-X4	Supplies Expense	390	
	Fuel Expense	155	
	Miscellaneous Expense	70	
	Cash		615
	To replenish petty cash; receipts on hand of $615 -- office supplies ($390), gasoline ($155), coffee and drinks ($70). Remaining cash in the fund was $385, bringing the total to $1,000 ($615 + $385).		

9.2 Cash Short and Over

Occasionally, errors will occur, and the petty cash fund will be out of balance. In other words, the sum of the cash and receipts differs from the correct Petty Cash balance. This might be the result of simple mistakes, such as math errors in making change, or perhaps someone failed to provide a receipt for an appropriate expenditure. Whatever the cause, the available cash must be brought back to the appropriate level. The journal entry to record full replenishment may require an additional debit (for shortages) or credit (for overages) to Cash Short (Over). In the following entry, $635 is placed back into the fund, even though receipts amount to only $615. The difference is debited to Cash Short (Over):

2-28-X4	Supplies Expense	390	
	Fuel Expense	155	
	Miscellaneous Expense	70	
	Cash Short (Over)	20	
	Cash		635
	To replenish petty cash; receipts on hand of $615 -- office supplies ($390), gasoline ($155), coffee and drinks ($70). Remaining cash in the fund was $365, bringing the total to $980 ($615 + $365; a $20 shortage was noted and replenished.		

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The Cash Short (Over) account is an income statement type account. It is also applicable to situations other than petty cash. For example, a retailer will compare daily cash sales to the actual cash found in the cash register drawers. If a surplus or shortage is discovered, the difference will be recorded in Cash Short (Over); a debit balance indicates a shortage (expense), while a credit represents an overage (revenue). As a means of enforcing accountability, some companies may pressure employees to reimburse cash shortages.

9.3 Increasing the Base Fund

As a company grows, it may find a need to increase the base size of its petty cash fund. The entry to increase the fund would be identical to the first entry illustrated above; that is, the amount added to the base amount of the fund would be debited to Petty Cash and credited to Cash. Otherwise, take note that the only entry to the Petty Cash account occurred when the fund was established -- subsequent reimbursements of the fund did not change the Petty Cash account balance.

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10. Trading Securities

From time to time a business may invest cash in stocks of other corporations. Or, a company may buy other types of corporate or government securities. Accounting rules for such investments depend on the "intent" of the investment. If these investments were acquired for long-term purposes, or perhaps to establish some form of control over another entity, the investments are classified as noncurrent assets. The accounting rules for those types of investments are covered in subsequent chapters. But, when the investments are acquired with the simple intent of generating profits by reselling the investment in the very near future, such investments are classified as current assets (following cash on the balance sheet). These investments are appropriately known as "trading securities."

Trading securities are initially recorded at cost (including brokerage fees). However, the value of these readily marketable items may fluctuate rapidly. Subsequent to initial acquisition, trading securities are to be reported at their fair value. The fluctuation in value is reported in the income statement as the value changes. This approach is often called "mark-to-market" or "fair value" accounting. Fair value is defined as the price that would be received from the sale of an asset in an orderly transaction between market participants.

10.1 An Illustration

Assume that Webster Company's management was seeing a pickup in their business activity, and believed that a similar uptick was occurring for its competitors as well. One of its competitors, Merriam Corporation, was a public company, and its stock was trading at $10 per share. Webster had excess cash earning very low rates of interest, and decided to invest in Merriam -- intending to sell the investment in the very near future for a quick profit. The following entry was needed on March 3, 20X6, the day Webster bought stock of Merriam:

3-3-X6	Trading Securities	50,000	
	Cash		50,000
	To record the purchase of 5,000 shares of Merriam stock at $10 per share		

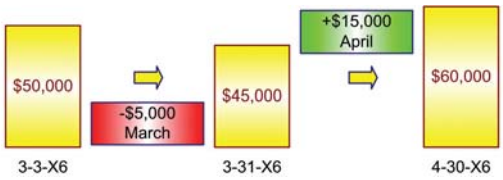
Next, assume that financial statements were being prepared on March 31. Despite Webster's plans for a quick profit, the stock declined to $9 per share by March 31. Webster still believes in the future of this investment, and is holding all 5,000 shares. But, accounting rules require that the investment "be written down" to current value, with a corresponding charge against income. The charge against income is recorded in an account called Unrealized Loss on Investments:

3-31-X6	Unrealized Loss on Investments	5,000	
	Trading Securities		5,000
	To record a $1 per share decrease in the value of 5,000 shares of Merriam stock		

Notice that the loss is characterized as "unrealized." This term is used to describe an event that is being recorded ("recognized") in the financial statements, even though the final cash consequence has not yet been determined. Hence, the term "unrealized."

April had the intended effect, and the stock of Merriam bounced up $3 per share to $12. Still Webster decided to hang on for more. At the end of April, another entry is needed if financial statements are again being prepared:

4-30-X6	Trading Securities	15,000	
	Unrealized Gain on Investments		15,000
	To record a $3 per share increase in the value of 5,000 shares of Merriam stock		



Notice that the three journal entries now have the trading securities valued at $60,000 ($50,000 - $5,000 + $15,000). This is equal to their market value ($12 X 5,000 = $60,000). The income statement for March includes a loss of $5,000, but April shows a gain of $15,000. Cumulatively, the income statements show a total gain of $10,000 ($5,000 loss + $15,000 gain). This cumulative gain corresponds to the total increase in value of the original $50,000 investment. The preceding illustration assumed a single investment. However, the treatment would be the same even if the trading securities consisted of a portfolio of many investments. That is, each and every investment would be adjusted to fair value.

10.2 Rationale for Fair Value Accounting

The fair value approach is in stark contrast to the historical cost approach used for other assets like land, buildings, and equipment. The rationale is that the market value for trading securities is readily determinable, and the periodic fluctuations have a definite economic impact that should be reported. Given the intent to dispose of the investments in the near future, the belief is that the changes in value likely have a corresponding effect on the ultimate cash flows of the company. As a result, the accounting rules recognize those changes as they happen.

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10.3 Alternative: A Valuation Adjustments Account

As an alternative to directly adjusting the Trading Securities account, some companies may maintain a separate Valuation Adjustments account that is added to or subtracted from the Trading Securities account. The results are the same; the reasons for using the alternative approach is to provide additional information that may be needed for more complex accounting and tax purposes. One such purpose is to determine the "taxable gain or loss" on sale. Tax rules generally require comparing the sales price to the original cost (you may be surprised to learn that tax rules sometimes differ from accounting rules -- the mark-to-market approach used for accounting is normally not acceptable for tax purposes). There are also more involved accounting rules relating to measurement of the "realized" gains and losses when the securities are in fact sold. Those rules are ordinarily the subject of more advanced courses.

10.4 Dividend and Interest

Since trading securities are turned over rather quickly, the amount of interest and dividends received on those investments is probably not very significant. However, any dividends or interest received on trading securities is reported as income and included in the income statement:

9-15-X5	Cash	75	
	Dividend Income		75
	To record receipt of dividend on trading security investment		

The presence or absence of dividends or interest on trading securities does not change the basic mark-to-market valuation for the Trading Securities account.

10.5 Derivatives

Beyond the rather straight-forward investments in trading securities are an endless array of more exotic investment options. Among these are commodity futures, interest rate swap agreements, options related agreements, and so on. These investments are generally referred to as derivatives, because their value is based upon or derived from something else (e.g., a cotton futures contract takes its value from cotton, etc.). The underlying accounting approach follows that for trading securities. That is, such instruments are initially measured at fair value, and changes in fair value are recorded in income as they happen.