

Chapter Three

Accounting cycle for merchandising business

3.1 Characteristics of merchandising business

The primary differences between a service business and a merchandising business relates to revenue activities. Service businesses involve in service provision to generate revenues while merchandising businesses involve in buying and selling of merchandise inventory to generate revenue. A business that earns its revenue through buying and selling goods and services to its customers is merchandising business.

Merchandise inventories: are goods that are held to be sold to customers in the normal course of business activities (products that a company owns and intends to sell in its normal operations of business). Merchandise inventories are reported as a current asset on the balance sheet. A merchandise business must first purchase merchandises to resell to its customers. When these merchandises are sold, the revenue is reported as sales and its cost is recognized as an expense, called cost of goods sold.

The main difference between the accounting cycle of service business and merchandising business lies on the reporting of income statement.

Income statement	
Service business	merchandising business
Fees earned..... xx	Sales.....xx
<u>Less</u> operating expense..... xx	<u>less</u> cost of goods sold.....xx
Net income/net loss..... <u>xxx</u>	Gross profit.....xx
	Less operating expense.....xx
	Net income/ loss..... <u>xxx</u>

4.2. Accounting for purchases of merchandises

There are two inventory systems; perpetual inventory systems and periodic inventory systems. 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.

Under the periodic inventory system, the inventory records do not show the amount available for sale or the amount sold during the period. Merchandise inventory at the end of the period is subtracted from the merchandise available for sale to determine the cost of merchandise sold. The merchandise inventory at the end of the period is determined by taking a physical count of inventory on hand. The perpetual inventory system is widely used by companies who use computerized systems.

3.2.1. Perpetual Inventory System

Under the perpetual inventory system, the buyer initially debits Merchandise Inventory for the amount of the invoice.

Example

May 2. ABC Co. Purchased \$5,000 of merchandise on account from Delta Data Link. ABC Co. would record this transaction as follows;

Merchandise Inventory	5,000
Accounts Payable—Delta Data Link	5,000

If purchase is made on cash, instead of Accounts payable, cash would be credited.

Purchases Discounts; refers to the cash discount given by the seller and taken by the buyer for early payment of an invoice. Purchases discounts taken by a buyer reduce the cost of the merchandise purchased. It is the means of encouraging buyers for their early payment of their credits. Examples of credit terms; 2/10, 1/15, n/30, n/eom. 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* (end of month).

May 2. ABC Co. purchased \$5,000 of merchandise on account from Delta Data Link, terms 2/10, n/30.

ABC company paid its liability on may 12 (with in discount period). In this situation, the journal entry would be as follows;

Assume that ABC co. does not take the discount, but instead pays the invoice on June 1. In this case, ABC co would record the payment on June 1 as follows:

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, 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).

May 2. Merchandise Inventory	5,000
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	Accounts Payable—Delta Data Link	5,000
May 4.	Accounts Payable—Delta Data Link	3,000
	Merchandise Inventory	3,000
May 12.	Accounts Payable—Delta Data Link	2,000
	Cash	1,960
	Merchandise Inventory	40

Paid invoice $[(\$5,000 - \$3,000) * 2\% = \$40; \$2,000 - \$40 = \$1,960]$.

3.3. Accounting for Sales of Merchandises

Merchandise transactions are recorded using the rules of debit and credit that we described and illustrated in Chapter 2.

Cash Sales: A business may sell merchandise for cash. Cash sales are normally entered on a cash register and recorded in the accounts. Using the perpetual inventory system, the cost of merchandise sold and the decrease in merchandise inventory are also recorded. In this way, the merchandise inventory account indicates the amount of merchandise on hand (not sold). To illustrate, assume that on January 3, X co. sells merchandise for \$1,800. The cost of merchandise sold is \$1,200. These cash sales are recorded as follows:

Cash	1,800	
	Sales	1,800
Cost of Merchandise Sold	1,200	
	Merchandise Inventory	1,200

Sales may be made to customers using credit cards such as MasterCard or VISA. Such sales are recorded as cash sales. This is because these sales are normally processed by a clearing-house that contacts the bank that issued the card. The issuing bank then electronically transfers cash directly to the retailer's bank account. Thus, the retailer normally receives cash within a few days of making the credit card sale.

Any processing fees charged by the clearing-house or issuing bank are periodically recorded as an expense. This expense is normally reported on the income statement as an administrative expense. To illustrate, assume that X co. paid credit card processing fees of \$48 on January 31. These fees would be recorded as follows:

Credit Card Expense	48	
Cash		48

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. An example of an entry for X co. sale on account of \$510 follows. The cost of merchandise sold was \$280.

Accounts Receivable	510	
Sales		510
Cost of Merchandise Sold	280	
Merchandise Inventory		280

Sales Discounts: The terms of a sale are normally indicated on the **invoice** or bill that the seller sends to the buyer. Discounts taken by the buyer for early payment are recorded as sales discounts by the seller. Managers usually want to know the amount of the sales discounts for a period. For this reason, sales discounts are recorded in a separate sales discounts account, which is a *contra* (or *offsetting*) account to Sales.

Example: Jan 12. ABC Co. sold merchandise to Omega Technologies for \$1,500 on account, terms 2/10, n/eom.

Accounts Receivable	1, 500	
Sales		1,500

ABC Co. receives cash from Omega on Jan 22 (within discount period).

Cash (1,500 – (1,500 * 2%))	1,470	
Sales discounts (1,500 * 2%)	30	
Accounts Receivable		1,500

If the buyer does not take the discount, the total amount is due within 30 days.

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 sales 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* (or *offsetting*) account to Sales. 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 merchandise.

Example: Jan. 13 ABC Co. returned \$225 of the merchandise sold on Jan 12. Assuming that the cost of the merchandise returned is \$140, the sales return and allowance would be recorded as follows:

Sales Returns and Allowances	225	
Accounts Receivable—Krier Company		225
Merchandise Inventory	140	
Cost of Merchandise Sold		140

A buyer may pay for merchandise and then later return it. In this case, the seller may do one of the following:

1. Issue a credit that is applied against the buyer's other receivables.
2. Issue cash refund.

If the credit is applied against the buyer's other receivables, the seller records the credit with entries similar to those shown above. If cash is refunded, the seller debits Sales Returns and Allowances and credits Cash.

Freight, Sales Taxes, and Trade Discounts

Purchases and sales of merchandise often involve freight and sales taxes. Also, the seller may offer buyers trade discounts.

Freight

The terms of a sale indicate when ownership (title) of the merchandise passes from the seller to the buyer. This point determines whether the buyer or the seller pays the freight costs.

The ownership of the merchandise may pass to the buyer when the seller delivers the merchandise to the freight carrier. In this case, the terms are said to be **FOB (free on board) shipping point**. This term means that the buyer pays the freight costs from the shipping point to

the final destination. Such costs are part of the buyer's total cost of purchasing inventory and are added to the cost of the inventory by debiting Merchandise Inventory.

To illustrate, assume that on June 10, ABC Co. purchased merchandise as follows:

June 10. Purchased merchandise from Magna Data, \$900, terms FOB shipping point.

10. Paid freight of \$50 on June 10 purchase from Magna Data.

ABC Co. would record these two transactions as follows:

Merchandise Inventory	900	
Accounts Payable—Magna Data		900
Merchandise Inventory	50	
Cash		50

The ownership of the merchandise may pass to the buyer when the buyer receives the merchandise. In this case, the terms are said to be **FOB (free on board) destination**. This term means that the seller pays the freight costs from the shipping point to the buyer's final destination. When the seller pays the delivery charges, the seller debits Delivery Expense or Freight Out. Delivery Expense is reported on the seller's income statement as a selling expense.

To illustrate, assume that NetSolutions sells merchandise as follows:

June 15. Sold merchandise to Kranz Company on account, \$700, terms FOB destination. The cost of the merchandise sold is \$480.

15. NetSolutions pays freight of \$40 on the sale of June 15.

NetSolutions records the sale, the cost of the sale, and the freight cost as follows:

Accounts Receivable—Kranz Company	700	
Sales		700
Cost of Merchandise Sold	480	
Merchandise Inventory		480
Delivery Expense	40	
Cash		40

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.

To illustrate, assume that NetSolutions sells merchandise as follows:

June 20. Sold merchandise to Planter Company on account, \$800, terms FOB shipping point. NetSolutions paid freight of \$45, which was added to the invoice. The cost of the merchandise sold is \$360.

NetSolutions records the sale, the cost of the sale, and the freight as follows:

Accounts Receivable—Planter Company	800	
Sales		800
Cost of Merchandise Sold	360	
Merchandise Inventory		360
Accounts Receivable—Planter Company	45	
Cash		45

Sales Taxes

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 a sale is made on account, the seller charges the tax to the buyer by debiting Accounts Receivable. The seller credits the sales account for the amount of the sale and credits the tax to Sales Tax Payable. For example, the seller would record a sale of \$100 on account, subject to a tax of 6%, as follows:

Accounts Receivable—Lemon Co.	106	
Sales		100
Sales Tax Payable		6

On a regular basis, the seller pays to the taxing authority (state) the amount of the sales tax collected. The seller records such a payment as follows:

Sales Tax Payable	2,500	
Cash		2,500

Trade Discounts

Wholesalers are companies that sell merchandise to other businesses rather than to the public. Many wholesalers publish sales catalogs. Rather than updating their catalogs, wholesalers may publish price updates. These updates may include large discounts from the catalog list prices. In addition, wholesalers often offer special discounts to government agencies or businesses that order large quantities. Such discounts are called **trade discounts**.

Sellers and buyers do not normally record the list prices of merchandise and trade discounts in their accounts. For example, assume that an item has a list price of \$1,000 and a 40% trade discount. The seller records the sale of the item at \$600 [\$1,000 less the trade discount of \$400 (\$1,000 * 40%)]. Likewise, the buyer records the purchase at \$600.

<u>Buyer</u>	<u>seller</u>
Merchandise inventory.....600	Account receivable/cash.....600
Account payable/cash.....600	sales.....600

3.4. Periodic Inventory System

Throughout this chapter, the perpetual inventory system was used to record purchases and sales of merchandise. Not all merchandise businesses, however, use the perpetual inventory system. For example, small merchandise businesses, such as a local hardware store, may use a manual accounting system. A manual perpetual inventory system is time consuming and costly to maintain. In this case, the periodic inventory system may be used.

Cost of Merchandise Sold Using the Periodic Inventory 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;

Merchandise inventory, January 1, 2011		xxx
Purchases	xxx	
Less: Purchases returns and allowances	xxx	
Purchases discounts	<u>xxx</u>	<u>xxx</u>
Net purchases	xxx	
Add freight in	<u>xxx</u>	
Cost of merchandise purchased		<u>xxx</u>
Merchandise available for sale		xxx
Less: merchandise inventory, December 31, 2011		<u>xxx</u>
Cost of merchandise sold		<u>xxx</u>

Or $CGS = BI + \text{Cost of merchandise purchased} - EI = BI + CMP - EI$

Cost of merchandise purchased = net purchase + transportation in

$CGAFS = BI + CMP$

CGAFS= Cost of goods available for sale

CGAFS-EI=CGS

Note - Purchase returns & allowances and purchase discounts are deducted from the total purchases to yield the net purchases.

- Transportation costs are added to the net purchases to yield cost of merchandise purchased.
- The beginning inventory is added to the cost of merchandise purchase to yield the merchandise available for sale
- Ending inventory is subtracted from merchandise available for sale to yield cost of merchandise sold.

Example: Assume that at the end of year 2003 physical count made by Guna trading company reveals merchandise of \$20,000 remains on hand. Assume also again during the following year (2004) Guna trading company purchases additional worth of \$120,000, received credit for purchase returns and allowance \$3,500, takes purchase discount of \$1500 and pays transportation cost of \$7,500. And the physical count at the end of the period shows an inventory of \$35,000. Note that the ending inventory of previous period (2003) becomes the beginning inventory of this period. Determine the cost of goods sold.

Required: Determine the net purchase, the cost of merchandise purchased, cost of merchandise available for sale, and cost of merchandise (goods) sold

Beginning inventory (2004)	\$20,000
Purchases	\$120,000
<u>Less</u> purchase returns & allowance.....	\$3500
Purchase discount.....	<u>1500</u> (5,000)
<u>Add:</u> Freight in.....	7,500
Cost of goods purchased.....	<u>122,500</u>
Cost of goods available for sale.....	142,500
<u>Less</u> ending inventory (December, 2004).....	<u>35,000</u>
Cost of goods sold.....	<u>\$107,500</u>

3.4.1. Recording Merchandise Transactions under the Periodic Inventory System

Using the periodic inventory system, purchases of inventory are not recorded in the merchandise inventory account. Instead, purchases, purchases discounts, and purchases returns and

allowances accounts are used. In addition, the sales of merchandise are not recorded in the inventory account. Thus, there is no detailed record of the amount of inventory on hand at any given time. At the end of the period, a physical count of merchandise inventory on hand is taken. This physical count is used to determine the cost of merchandise sold.

3.4.1.1. Accounting for Purchases of Transactions

Purchases of inventory are recorded in a purchases account rather than in the merchandise inventory account. Purchase is debited for the invoice amount of a purchase.

Purchases Discounts

Purchases discounts are normally recorded in a separate purchases discounts account. The balance of the purchases discounts account is reported as a deduction from Purchases for the period. Thus, Purchases Discounts is a contra (or offsetting) account to Purchases.

Purchases Returns and Allowances

Purchases returns and allowances are recorded in a similar manner as purchases discounts. A separate purchases returns and allowances account is used to record returns and allowances. Purchases returns and allowances are reported as a deduction from Purchases for the period. Thus, Purchases Returns and Allowances is a contra (or offsetting) account to Purchases.

Freight In

When merchandise is purchased on FOB shipping point, the buyer pays for the freight. Under the periodic inventory system, freight paid for merchandise purchased on FOB shipping point is debited to Freight In, Transportation In, or a similar account.

Example June 2, ABC trading company purchased \$30,000 of merchandise from XYZ Company paying \$20,000 cash and the remaining on account, terms 2/10, n/30. Transactions Record as follows:

Purchases.....	30,000
Cash.....	20,000
Account payable.....	10,000

Purchase discount

From above example, if ABC trading pays the balance \$10,000 on June 12, the purchase discount could be computed and recorded as follows.

June 12, Account payable.....10,000
 Cash.....9,800
 Purchase discount.....200
 (Purchase discount = $10,000 \times 2\%$)

If ABC trading company fails to take discount and full payment will be made on July 2

July, 2 Account payable.....10,000
 Cash.....10,000

Purchase return and allowance

Example, ABC trading company returned merchandise amounting \$1,000 from June 2 purchased and recorded the amount in cash. The entry is

Account payable.....1,000
 Purchase return and allowance.....1,000

3.4.1.2. Accounting for sales of merchandises

Example, merchandise business sold merchandise for \$1,500.

Cash /Accounts Receivable.....1,500
 Sales.....1,500

Sales discount

Example, Jamal PLC sold merchandise on account \$500 on January1, terms of 2/10, n/30.

Account receivable.....500
 Sales.....500

What will be the journal entry if the seller received cash within the discount period?

Cash.....490
Sales discount ($500 \times 2\%$).....10
 Account receivable.....500

For the buyer

Purchase.....500

Account payable.....	500
If the buyer remits the amount within the discount period	
Account payable.....	500
Cash.....	490
Purchase discount.....	10

Sales return and allowance - If the return or allowance is for a sale on account, the seller usually gives the buyer a credit memorandum. This memorandum shows the account for which the buyer is to be credited and the reason therefore. The effect of sales return or allowance is reduction in sales revenue and a reduction in cash or account receivable. Example, a seller issued a credit memorandum for \$200 to customer on account for merchandise returned.

Sales return and allowance	200
Account receivable.....	200

3.5. Financial statements for a merchandising business

The basic financial statements for a merchandising enterprise, including the income statement, owner's equity, and balance sheet are similar to those of a service enterprise. The basic differences between the financial statements of a merchandising enterprises and a service enterprise includes the cost of merchandise sold section of the income statement and the inclusion of merchandise inventory on the balance sheet as a current asset.

Income statement - perpetual inventory system

There are two types of income statement for merchandise business.

- **Multiple income statement:** contains sections, sub sections, and sub totals.
 - ✓ **Revenue from sales** - This section of the multiple-step income statement consists of sales, sales returns and allowances, sales discounts, and net sales.
 - ✓ **Cost of Merchandise Sold/ Cost of Goods Sold or cost of sales** are the cost of the merchandise sold to customers.
 - ✓ **Gross profit** - The excess of net sales over the cost of merchandise sold. It is sometimes called gross profit on sales or gross margin
 - ✓ **Income from Operations** **Income from operations**, sometimes called **operating income**, is determined by subtracting operating expenses from gross profit. Operating expenses are normally classified as either selling

expenses or administrative expenses. **Selling expenses** are incurred directly in the selling of merchandise. Examples of selling expenses include sales salaries, store supplies used, depreciation of store equipment, delivery expense, and advertising. **Administrative expenses**, sometimes called **general expenses**, are incurred in the administration or general operations of the business. Examples of administrative expenses include office salaries, depreciation of office equipment, and office supplies used.

- ✓ **Other Income and Expense** Other income and expense items are not related to the primary operations of the business. **Other income** is revenue from sources other than the primary operating activity of a business. Examples of other income include income from interest, rent, and gains resulting from the sale of fixed assets. **Other expense** is an expense that cannot be traced directly to the normal operations of the business. Examples of other expenses include interest expense and losses from disposing of fixed assets. Other income and other expense are offset against each other on the income statement. If the total of other income exceeds the total of other expense, the difference is added to income from operations to determine net income. If the reverse is true, the difference is subtracted from income from operations.

Format of multiple income statement

XYZ Company

Income statement

For the year ended Dec 31, 20xx

Revenue from sales:

Sales XXX

Less: Sales returns and allowances xxx

Sales discounts xxx xxx

Net sales XXX

Cost of merchandise sold xxx

Gross profit XXX

Operating expenses:

Selling expenses:

Sales salaries expense	xxx
Advertising expense	xxx
Depreciation expense—store equipment ...	xxx
Delivery expense	xxx
Miscellaneous selling expense	xxx
Total selling expenses	xxx

Administrative expenses:

Office salaries expense	xxx
Rent expense	xxx
Depreciation expense—office equipment	xxx
Insurance expense	xxx
Office supplies expense	xxx
Misc. administrative expense	xxx
Total administrative expenses	xxx

Total operating expenses xxx

Income from operations xxx

Other income and expense:

Rent revenue	xxx
Interest expense	<u>xxx</u> <u>xxx</u>

Net income xxx

Single income statement: is an income statement in which the total of all expense is deducted from the total of all revenues to provide net income. It has the advantage of being simple. A criticism of the single-step form is that gross profit and income from operations are not reported.

Format of single income statement under perpetual inventory system

Durban Company

Income statement

For the year ended Dec. 31 20xx

Revenues:

Net sales ----- xxx

Rent income -----xxx

Total Revenue -----xxx

Expenses:

Cost merchandise sold ----- xxx

Selling expense ----- xxx

Administrative expense ----- xxx

Interest expense ----- xxx

Total expenses -----xxx

Net income -----xxx

3.6 Adjusting and closing entries for a merchandising business

Adjusting Entry for Inventory Shrinkage

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**.

To illustrate, NetSolutions' inventory records indicate the following on December 31, 2011:

	<u>Dec. 31, 2011</u>
Account balance of Merchandise Inventory	\$63,950
Physical merchandise inventory on hand	<u>62,150</u>
Inventory shrinkage	<u>\$1,800</u>

At the end of the accounting period, inventory shrinkage is recorded by the following adjusting entry:

Adjusting Entry

Cost of Merchandise Sold	1,800	
Merchandise Inventory		1,800

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.

Closing Entries under perpetual inventory system

The 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.

Closing entries

1. Sales	xxx	
Rent Revenue	xxx	
Income Summary		xxx
2. Income Summary	xxx	
Sales Returns and Allowances		xxx

Sales Discounts	xxx	
Cost of Merchandise Sold	xxx	
Sales Salaries Expense	xxx	
Advertising Expense	xxx	
Depr. Expense—Store Equipment	xxx	
Delivery Expense	xxx	
Miscellaneous Selling Expense	xxx	
Office Salaries Expense	xxx	
Rent Expense	xxx	
Depr. Expense—Office Equipment	xxx	
Insurance Expense	xxx	
Office Supplies Expense	xxx	
Misc. Administrative Expense	xxx	
Interest Expense	xxx	
3. Income Summary	xxx	
Chris Clark, Capital		xxx
4. Chris Clark, Capital	xxx	
Chris Clark, Drawing		xxx

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.

Closing Entries under the Periodic Inventory System

The closing entries differ in the periodic inventory system in that there is no cost of merchandise sold account to close to Income Summary. Instead, the purchases, purchases discounts, purchases returns and allowances, and freight in accounts are closed to Income Summary. In addition, the merchandise inventory account is adjusted to the end-of-period physical inventory count during the closing process.

The four closing entries under the periodic inventory system are as follows:

1. Debit each temporary account with a credit balance, such as Sales, for its balance and credit Income Summary. Since Purchases Discounts and Purchases Returns and Allowances are temporary accounts with credit balances, they are debited for their balances. In addition, Merchandise Inventory is debited for its end-of-period balance based on the end-of-period physical inventory.
2. Credit each temporary account with a debit balance, such as the various expenses, and debit Income Summary. Since Sales Returns and Allowances, Sales Discounts, Purchases, and Freight In are temporary accounts with debit balances, they are credited for their balances. In addition, Merchandise Inventory is credited for its balance as of the beginning of the period.
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.

Closing entries

1. Merchandise inventory	xxx	
Sales	xxx	
Purchases Returns and Allowances	xxx	
Purchases Discounts	xxx	
Rent Revenue	xxx	
Income Summary		xxx
2. Income Summary	xxx	
Merchandise Inventory		xxx
Sales Returns and Allowances		xxx
Sales Discounts		xxx
Purchases		xxx
Freight in		xxx
Sales Salaries Expense		xxx
Advertising Expense		xxx
Depr. Expense—Store Equipment		xxx
Delivery Expense		xxx
Miscellaneous Selling Expense		xxx

	Office Salaries Expense	xxx
	Rent Expense	xxx
	Depr. Expense—Office Equipment	xxx
	Insurance Expense	xxx
	Office Supplies Expense	xxx
	Misc. Administrative Expense	xxx
	Interest Expense	xxx
3. Income Summary	xxx	
	Chris Clark, Capital	xxx
4. Chris Clark, Capital	xxx	
	Chris Clark, Drawing	xxx