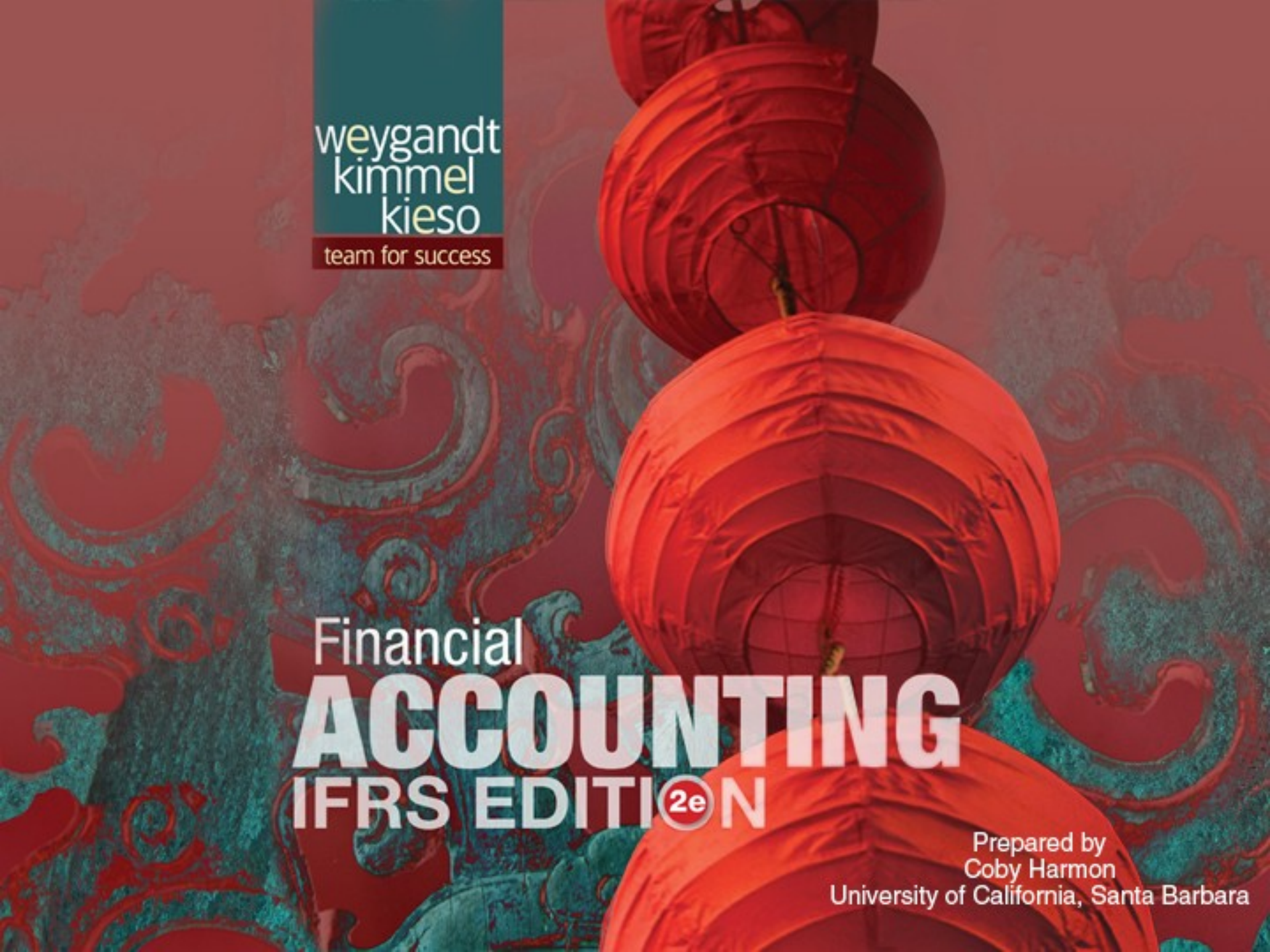

weygandt
kimmel
kieso
team for success
Financial
ACCOUNTING
IFRS EDITION 2e
Prepared by
Coby Harmon
University of California, Santa Barbara

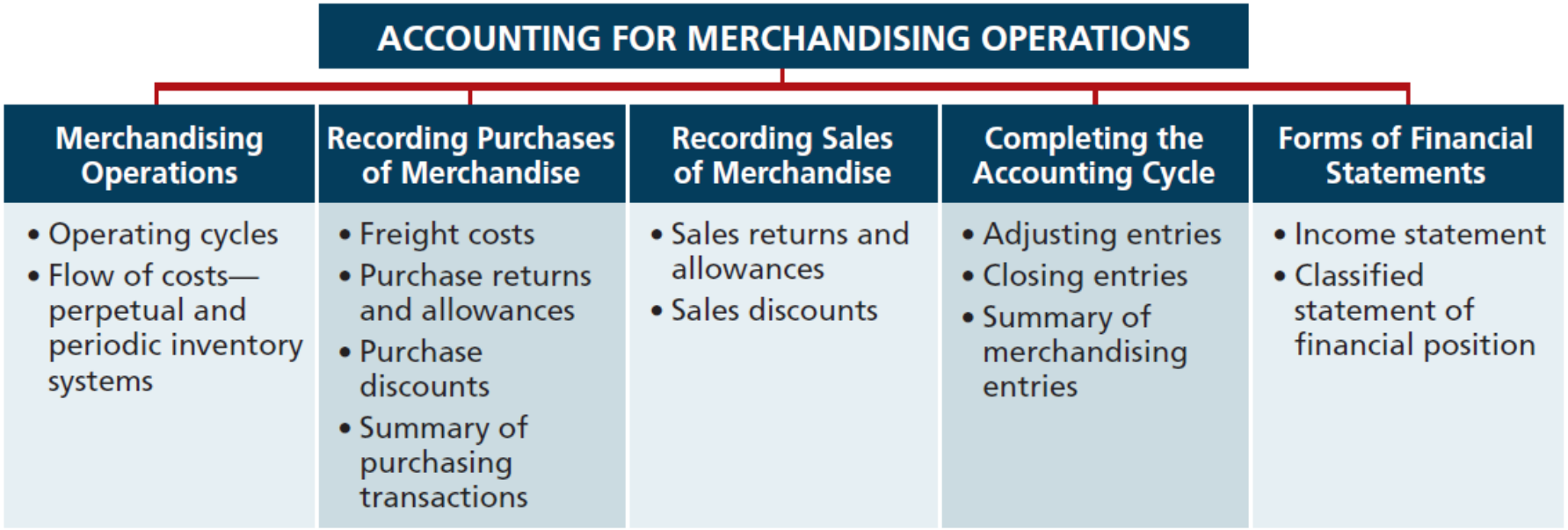
# Chapter 5 Accounting for Merchandising Operations

## Learning Objectives

***After studying this chapter, you should be able to:***

1. **Identify the differences between service and merchandising companies.**
2. **Explain the recording of purchases under a perpetual inventory system.**
3. **Explain the recording of sales revenues under a perpetual inventory system.**
4. **Explain the steps in the accounting cycle for a merchandising company.**
5. **Prepare an income statement for a merchandiser.**

# Preview of Chapter 5




Financial Accounting
IFRS Second Edition
Weygandt • Kimmel • Kieso

# Merchandising Operations

## Merchandising Companies

Buy and Sell Goods




The primary source of revenues is referred to as **sales revenue** or **sales**.



**LO 1 Identify the differences between service and merchandising companies.**

# Merchandising Operations

## Income Measurement

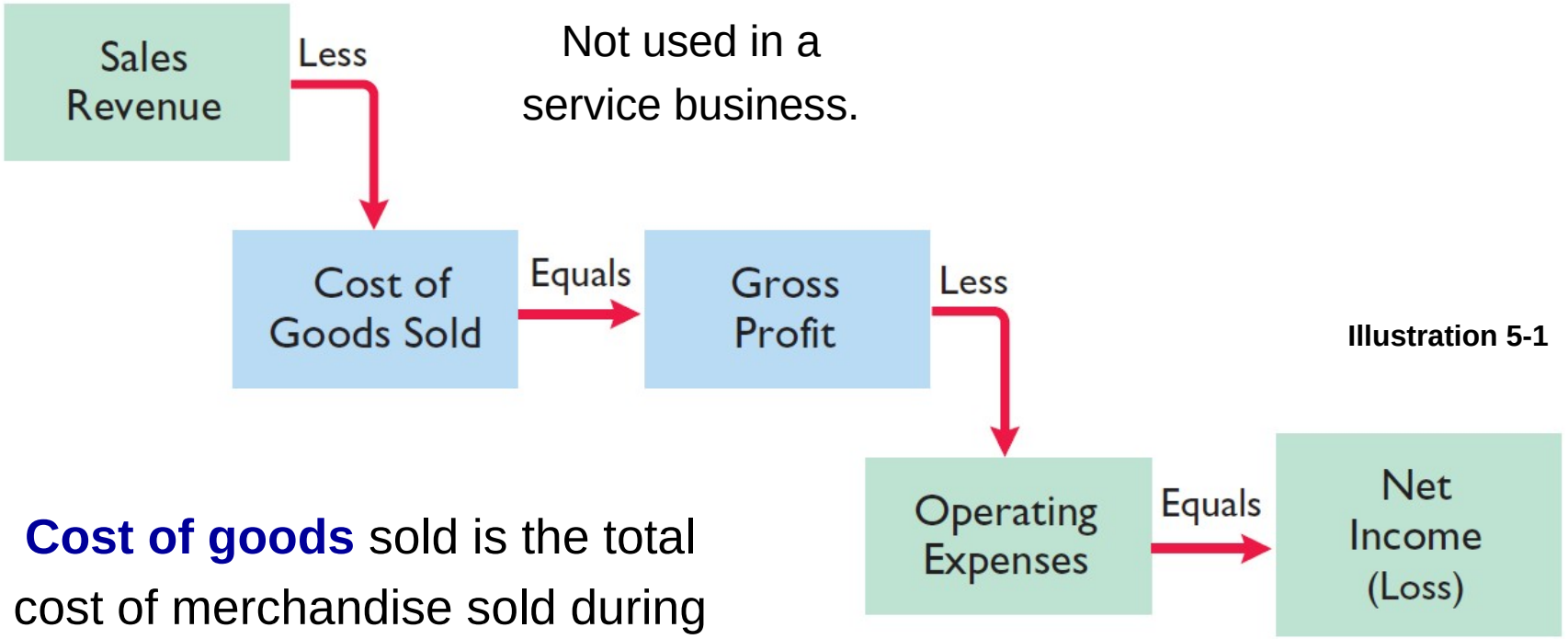



Illustration 5-1

**Cost of goods** sold is the total cost of merchandise sold during the period.



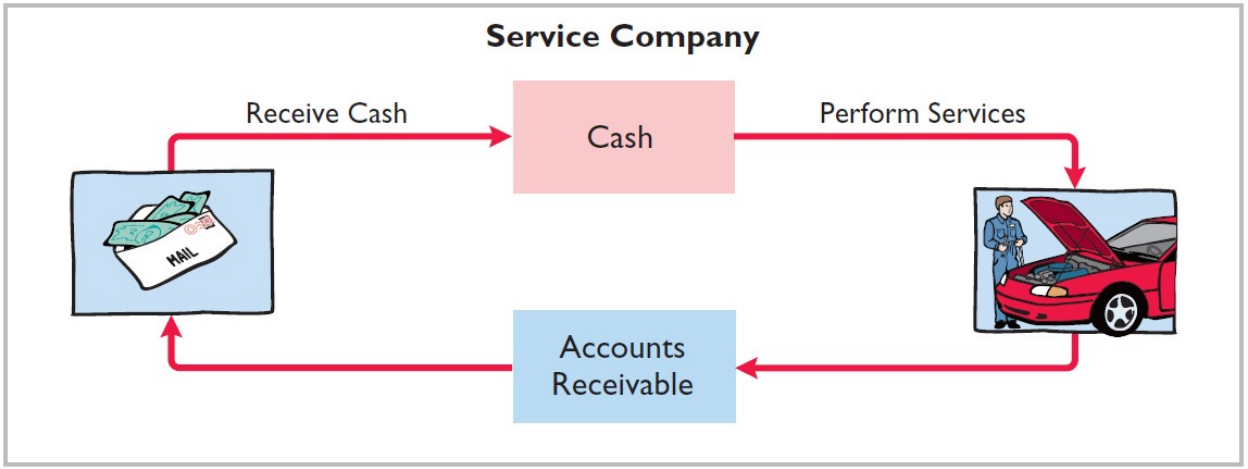
**LO 1 Identify the differences between service and merchandising companies.**

# Merchandising Operations

## Operating Cycles

The operating cycle of a **merchandising company** ordinarily is longer than that of a **service company**.

Illustration 5-2



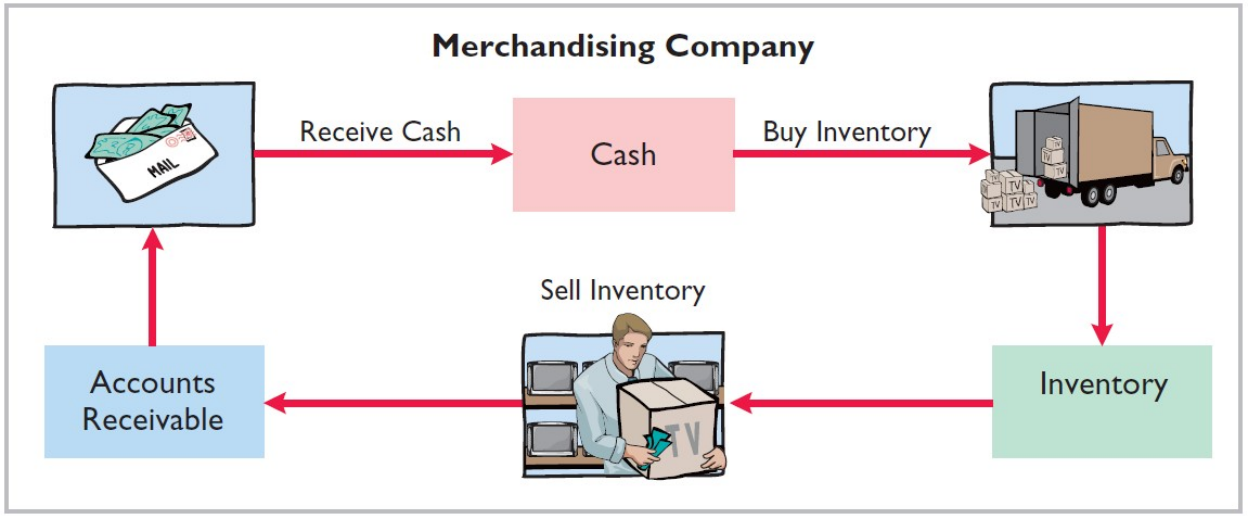




Illustration 5-3

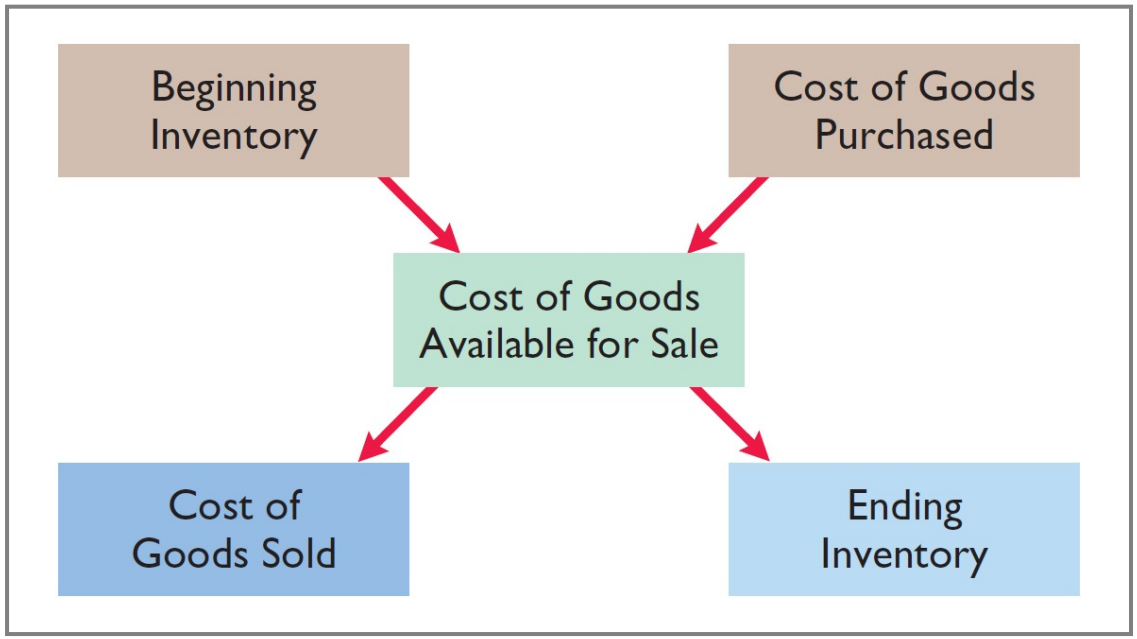


**LO 1 Identify the differences between service and merchandising companies.**

# Merchandising Operations

## Flow of Costs

Illustration 5-4




Companies use either a **perpetual inventory system** or a **periodic inventory system** to account for inventory.



**LO 1 Identify the differences between service and merchandising companies.**

# Merchandising Operations

## Flow of Costs

### Perpetual System

- Maintain detailed records of the cost of each inventory purchase and sale.
- Records continuously show inventory that should be on hand.
- Company determines cost of goods sold each time a sale occurs.



**LO 1 Identify the differences between service and merchandising companies.**

# Merchandising Operations

## Flow of Costs

### Periodic System

- Do not keep detailed records of the goods on hand.
- Cost of goods sold determined by count at the end of the accounting period.
- Calculation of Cost of Goods Sold:

| | |
|---|---|
| Beginning inventory | |
| $ 100,000 | |
| Add: Purchases, net | |
| 800,000 | |
| Goods available for sale | |

# Merchandising Operations

## Flow of Costs

### Additional Consideration

**Perpetual System:**

- Traditionally used for merchandise with high unit values.
- Provides better control over inventories.
- Requires additional clerical work and additional cost to maintain inventory records.



**LO 1 Identify the differences between service and merchandising companies.**

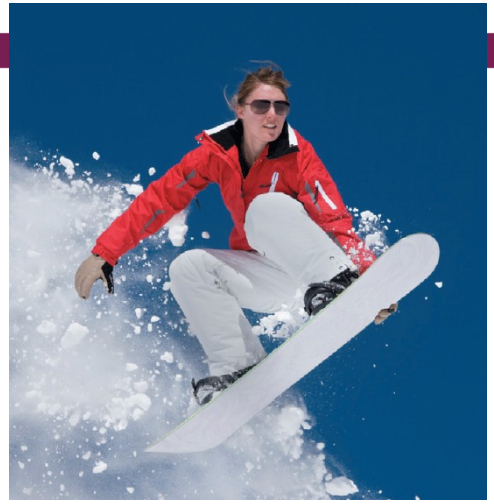
# INVESTOR INSIGHT



## Snowboard Company Improves Its Share Appeal

Investors are often eager to invest in a company that has a hot new product. However, when a fast-growing snowboard-maker issued ordinary shares to the public for the first time, some investors expressed reluctance to invest in it because of a number of accounting control problems. To reduce investor concerns, the company implemented a perpetual inventory system to improve its control over inventory. In addition, it stated that it would perform a physical inventory count every quarter until it felt that the perpetual inventory system was reliable.

? If a perpetual system keeps track of inventory on a daily basis, why do companies ever need to do a physical count? (See page 258.)



© Ben Blankenburg/iStockphoto

# Recording Purchases of Merchandise

- Made using **cash or credit** (on account).
- Normally **recorded when** goods are received.
- **Purchase invoice** should support each credit purchase.

**Illustration 5-6**

INVOICE NO. 731

PW AUDIO SUPPLY, INC.
27 CIRCLE DRIVE
AMSTERDAM, THE NETHERLANDS 1081

SOLD TO
Firm Name Sauk Stereo
Attention of James Hoover, Purchasing Agent
Address 125 Main Street
Oslo Norway 283

| Date 5/4/14 | Salesperson Malone | Terms 2/10, n/30 | FOB Shipping Point | |
|---|---|---|---|---|
| Catalog No. | Description | Quantity | Price | Amount |
| X572Y9820 | Printed Circuit Board-prototype | 1 | 2,300 | €2,300 |
| A2547Z45 | Production Model Circuits | 5 | 300 | 1,500 |
| IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS | | | TOTAL | €3,800 |

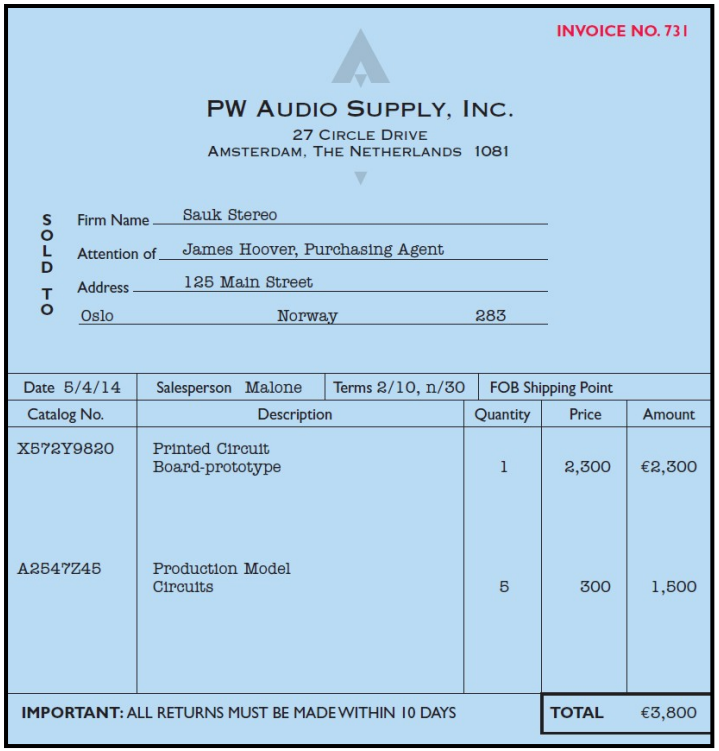


**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

**Illustration:** Sauk Stereo (the buyer) uses as a purchase invoice the sales invoice prepared by PW Audio Supply, Inc. (the seller). **Prepare the journal entry** for Sauk Stereo for the invoice from PW Audio Supply.

Illustration 5-6



INVOICE NO. 731

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27 CIRCLE DRIVE
AMSTERDAM, THE NETHERLANDS 1081

SOLD TO
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| X572Y9820 | Printed Circuit Board-prototype | 1 | 2,300 | €2,300 |
| A2547Z45 | Production Model Circuits | 5 | 300 | 1,500 |
| IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS | | | TOTAL | €3,800 |

| | | | |
|---|---|---|---|
| May 4 | Inventory | 3,800 | |
| | Accounts payable | | 3.800 |

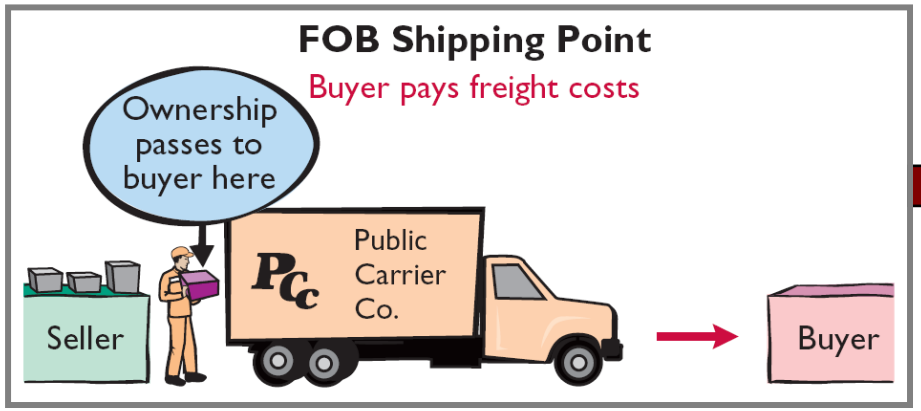


**LO 2 Explain the recording of purchases under a perpetual inventory system.**

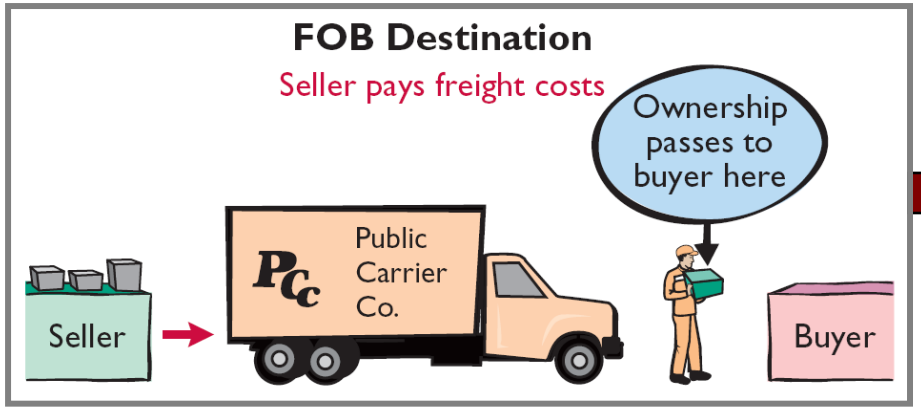
# Recording Purchases of Merchandise

## Freight Costs – Terms of Sale

**Illustration 5-7**
Shipping terms




Seller places goods Free On Board the carrier, and buyer pays freight costs.




Seller places goods Free On Board to the buyer's place of business, and seller pays freight costs.

Freight costs incurred by the seller are an **operating expense**.



LO 2

# Recording Purchases of Merchandise

**Illustration:** Upon delivery of the goods on May 6, **Sauk Stereo** (the buyer) pays Acme Freight Company €150 for **freight charges**, the entry on Sauk Stereo's books is:

| | | | |
|---|---|---|---|
| May 6 | Inventory | 150 | |
| | Cash | | 150 |

In contrast, if the freight terms on the invoice had required PW Audio Supply (the seller) to pay the **freight charges**, the entry by PW Audio Supply would have been:

| | | | |
|---|---|---|---|
| May 4 | Freight-out (Delivery expense) | 150 | |
| | Cash | | 150 |



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

## Purchase Returns and Allowances

**Purchaser may be dissatisfied** because goods are damaged or defective, of inferior quality, or do not meet specifications.

| Purchase Return | Purchase Allowance |
| --- | --- |
| Return goods for credit if the sale was made on credit, or for a cash refund if the purchase was for cash. | May choose to keep the merchandise if the seller will grant an allowance (deduction) from the purchase price. |



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

## Question

In a perpetual inventory system, a return of defective merchandise by a purchaser is recorded by crediting:

a. Purchases

b. Purchase Returns

c. Purchase Allowance

d. Inventory



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

## Purchase Discounts

**Credit terms** may permit buyer to claim a cash discount for prompt payment.

**Example:** Credit terms may read **2/10, n/30**.

**Advantages:**

- Purchaser saves money.
- Seller shortens the operating cycle.



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

## Purchase Discounts

| 2/10, n/30 | 1/10 EOM | n/10 EOM |
| --- | --- | --- |
| 2% discount if paid within 10 days, otherwise net amount due within 30 days. | 1% discount if paid within first 10 days of next month. | Net amount due within the first 10 days of the next month. |



LO 2 Explain the recording of purchases under a perpetual inventory system.

# Recording Purchases of Merchandise

**Illustration:** Assume that on May 8 Sauk Stereo returned to PW Audio Supply goods costing €300.

| | | | |
|---|---|---|---|
| May 8 | Accounts payable | 300 | |
| | Inventory | | 300 |



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

**Illustration:** Assume Sauk Stereo pays the balance due of €3,500 (gross invoice price of €3,800 less purchase returns and allowances of €300) on May 14, the last day of the discount period. Prepare the journal entry Sauk Stereo makes to record its May 14 payment.

| | | | |
|---|---|---|---|
| May 14 | Accounts payable | 3,500 | |
| | Cash | | 3,430 |
| | Inventory | | 70 |

(Discount = €3,500 x 2% = **€70**)



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

**Illustration:** If Sauk Stereo failed to take the discount, and instead made full payment of €3,500 on June 3, the journal entry would be:

| | | | |
|---|---|---|---|
| June 3 | Accounts payable | 3,500 | |
| | Cash | | 3,500 |



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

## Purchase Discounts

**Should discounts be taken** when offered?

| | |
|---|---|
| Discount of 2% on €3,500 | € 70.00 |
| €3,500 invested at 10% for 20 days | 19.18 |
| Savings by taking the discount | **€ 50.82** |

**Example:** 2% for 20 days = Annual rate of 36.5%
(365/20 = 18.25 twenty-day periods x 2% = 36.5%)



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Purchases of Merchandise

## Summary of Purchasing Transactions

**Inventory**

| | Debit | Credit | |
|---|---|---|---|
| 4th - Purchase | €3,800 | €300 | 8th - Return |
| 6th – Freight-in | 150 | 70 | 14th - Discount |
| Balance | €3,580 | | |



**LO 2 Explain the recording of purchases under a perpetual inventory system.**

# Recording Sales of Merchandise

- Made using **cash or credit** (on account).
- Normally recorded when earned, usually when goods transfer from seller to buyer.
- **Sales invoice** should support each credit sale.

**Illustration 5-6**

INVOICE NO. 731

PW AUDIO SUPPLY, INC.
27 CIRCLE DRIVE
AMSTERDAM, THE NETHERLANDS 1081

SOLD TO
Firm Name Sauk Stereo
Attention of James Hoover, Purchasing Agent
Address 125 Main Street
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| Date 5/4/14 | Salesperson Malone | Terms 2/10, n/30 | FOB Shipping Point | |
|---|---|---|---|---|
| Catalog No. | Description | Quantity | Price | Amount |
| X572Y9820 | Printed Circuit Board-prototype | 1 | 2,300 | €2,300 |
| A2547Z45 | Production Model Circuits | 5 | 300 | 1,500 |
| IMPORTANT: ALL RETURNS MUST BE MADE WITHIN 10 DAYS | | | TOTAL | €3,800 |

**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# Recording Sales of Merchandise

## Journal Entries to Record a Sale

| | | | | |
|---|---|---|---|---|
| **#1** | Cash **or** Accounts receivable | XXX | | **Selling Price** |
| | Sales revenue | | XXX | |
| **#2** | Cost of goods sold | XXX | | **Cost** |
| | Inventory | | XXX | |



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# Recording Sales of Merchandise

**Illustration:** Assume PW Audio Supply records its May 4 sale of €3,800 to Sauk Stereo on account as follows. Assume the merchandise cost PW Audio Supply €2,400.

| | | | |
|---|---|---|---|
| May 4 | Accounts receivable | 3,800 | |
| | Sales revenue | | 3,800 |
| May 4 | Cost of goods sold | 2,400 | |
| | Inventory | | 2,400 |



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

## ANATOMY OF A FRAUD[1]

Holly Harmon was a cashier at a national superstore for only a short while when she began stealing merchandise using three methods. First, her husband or friends took UPC labels from cheaper items and put them on more expensive items. Holly then scanned the goods at the register. Second, Holly rang an item up but then voided the sale and left the merchandise in the shopping cart. A third approach was to put goods into large plastic containers. She rang up the plastic containers but not the goods within them. One day, Holly did not call in sick or show up for work. In such instances, the company reviews past surveillance tapes to look for suspicious activity by employees. This enabled the store to observe the thefts and to identify the participants.

Total take: $12,000

**The Missing Controls**

*Source:* Adapted from Wells, *Fraud Casebook* (2007), pp. 251–259.

# Recording Sales of Merchandise

## Sales Returns and Allowances

- **"Flipside"** of purchase returns and allowances.
- **Contra-revenue** account (debit).
- **Sales not reduced** (debited) because:
  - Would obscure importance of sales returns and allowances as a percentage of sales.
  - Could distort comparisons.



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# Recording Sales of Merchandise

**Illustration:** Prepare the entry PW Audio Supply would make to record the credit for returned goods that had a €300 selling price (assume a €140 cost). Assume the **goods were not defective**.

| | | | |
|---|---|---|---|
| May 8 | Sales returns and allowances | 300 | |
| | Accounts receivable | | 300 |
| May 8 | Inventory | 140 | |
| | Cost of goods sold | | 140 |



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# Recording Sales of Merchandise

**Illustration:** Assume the **returned goods were defective** and had a scrap value of €50, PW Audio would make the following entries:

| | | | |
|---|---|---|---|
| May 8 | Sales returns and allowances | 300 | |
| | Accounts receivable | | 300 |
| May 8 | Inventory | 50 | |
| | Cost of goods sold | | 50 |



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# Recording Sales of Merchandise

## Question

The cost of goods sold is determined and recorded each time a sale occurs in:

a. periodic inventory system only.

b. a perpetual inventory system only.

c. both a periodic and perpetual inventory system.

d. neither a periodic nor perpetual inventory system.



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# ACCOUNTING ACROSS THE ORGANIZATION

## Should Costco Change Its Return Policy?

In most industries, sales returns are relatively minor. But returns of consumer electronics can really take a bite out of profits. Recently, the marketing executives at Costco Wholesale Corp. (USA) faced a difficult decision. Costco has always prided itself on its generous return policy. Most goods have had an unlimited grace period for returns. A new policy will require that certain electronics must be returned within 90 days of their purchase. The reason? The cost of returned products such as high-definition TVs, computers, and iPods cut an estimated 8¢ per share off Costco's earnings per share, which was $2.30.

*Source:* Kris Hudson, "Costco Tightens Policy on Returning Electronics," *Wall Street Journal* (February 27, 2007), p. B4.

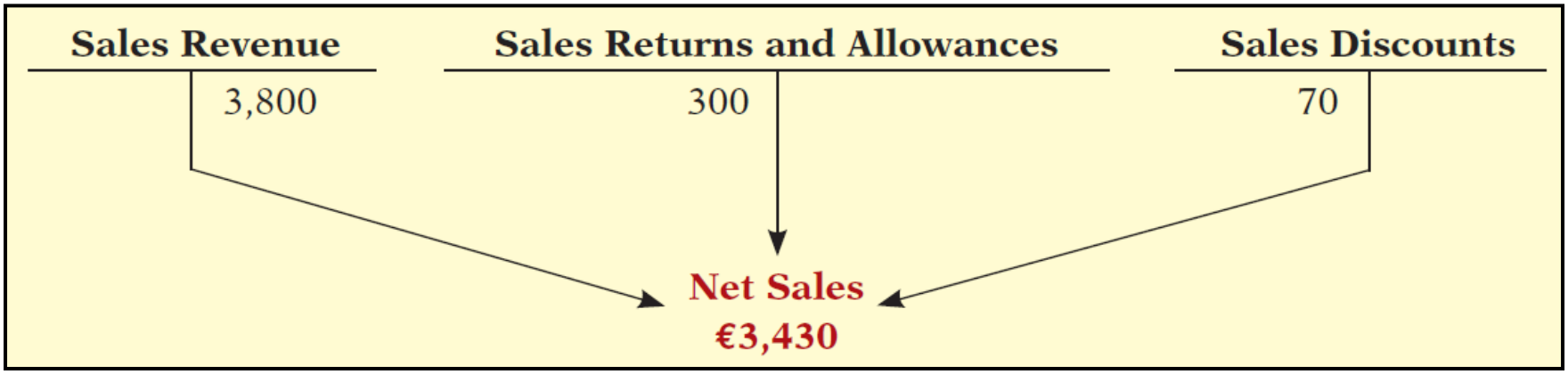
? If a company expects significant returns, what are the implications for revenue recognition? (



# Recording Sales of Merchandise

## Sales Discount

- Offered to customers to **promote prompt payment**.
- **"Flipside"** of purchase discount.
- **Contra-revenue** account (debit).






**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

# Recording Sales of Merchandise

**Illustration:** Assume Sauk Stereo pays the balance due of €3,500 (gross invoice price of €3,800 less purchase returns and allowances of €300) on May 14, the last day of the discount period. Prepare the journal entry PW Audio Supply makes to record the receipt on May 14.

| | | | |
|---|---|---|---|
| May 14 | Cash | 3,430 | |
| | Sales discounts | 70 * | |
| | Accounts receivable | | 3,500 |

* [(€3,800 – €300) X 2%]



**LO 3 Explain the recording of sales revenues under a perpetual inventory system.**

## PEOPLE, PLANET, AND PROFIT INSIGHT



### Selling Green

Here is a question an executive of PepsiCo (USA) was asked: Should PepsiCo market green? The executive indicated that the company should, as he believes it's the No. 1 thing consumers all over the world care about. Here are some thoughts on this issue:

If you are going to market green, what are some things we've learned? I'll share with you one thing we've learned at PepsiCo.

Sun Chips are part of the food business I run. It's a "healthy snack." We decided that Sun Chips, if it's a healthy snack, should be made in facilities that have a net-zero footprint. In other words, I want off the electric grid everywhere we make Sun Chips. We did that. Sun Chips should be made in a facility that puts back more water than it uses. It does that. And we partnered with our suppliers and came out with the world's first compostable chip package.

Now, there was an issue with this package: It was louder than the New York subway, louder than jet engines taking off. What would a company that's committed to green do: walk away or stay committed? If your people are passionate, they're going to fix it for you as long as you stay committed. Six months later, the compostable bag has half the noise of our current package.

So the view today is: we should market green, we should be proud to do it . . . it has to be a 360 process, both internal and external. And if you do that, you can monetize environmental sustainability for the shareholders.

*Source:* "Four Problems—and Solutions," *Wall Street Journal* (March 7, 2011), p. R2.



What is meant by "monetize environmental sustainability" for shareholders? (See page 259.)

# Completing the Accounting Cycle

## Adjusting Entries

- Generally the same as a service company.
- One additional adjustment to make the records agree with the actual inventory on hand.
- **Involves adjusting Inventory and Cost of Goods Sold**.



**LO 4 Explain the steps in the accounting cycle for a merchandising company.**

# Completing the Accounting Cycle

**Illustration:** PW Audio Supply has an unadjusted balance of €40,500 in Inventory. Through a physical count, PW Audio determines that its actual inventory at year-end is €40,000. The company would make an adjusting entry as follows.

| | | |
|---|---|---|
| Cost of goods sold | 500 | |
| Inventory | | 500 |



**LO 4 Explain the steps in the accounting cycle for a merchandising company.**

# Completing the Accounting Cycle

## Closing Entries

| | | | |
|---|---|---|---|
| Dec. 31 | Sales Revenue | 480,000 | |
| | Income Summary | | 480,000 |
| | (To close income statement accounts with credit balances) | | |
| 31 | Income Summary | 450,000 | |
| | Cost of Goods Sold | | 316,000 |
| | Salaries and Wages Expense | | 64,000 |
| | Utilities Expense | | 17,000 |
| | Advertising Expense | | 16,000 |
| | Sales Returns and Allowances | | 12,000 |
| | Sales Discounts | | 8,000 |
| | Depreciation Expense | | 8,000 |
| | Freight-Out | | 7,000 |
| | Insurance Expense | | 2,000 |
| | (To close income statement accounts with debit balances) | | |



**LO 4 Explain the steps in the accounting cycle for a merchandising company.**

# Completing the Accounting Cycle

## Closing Entries

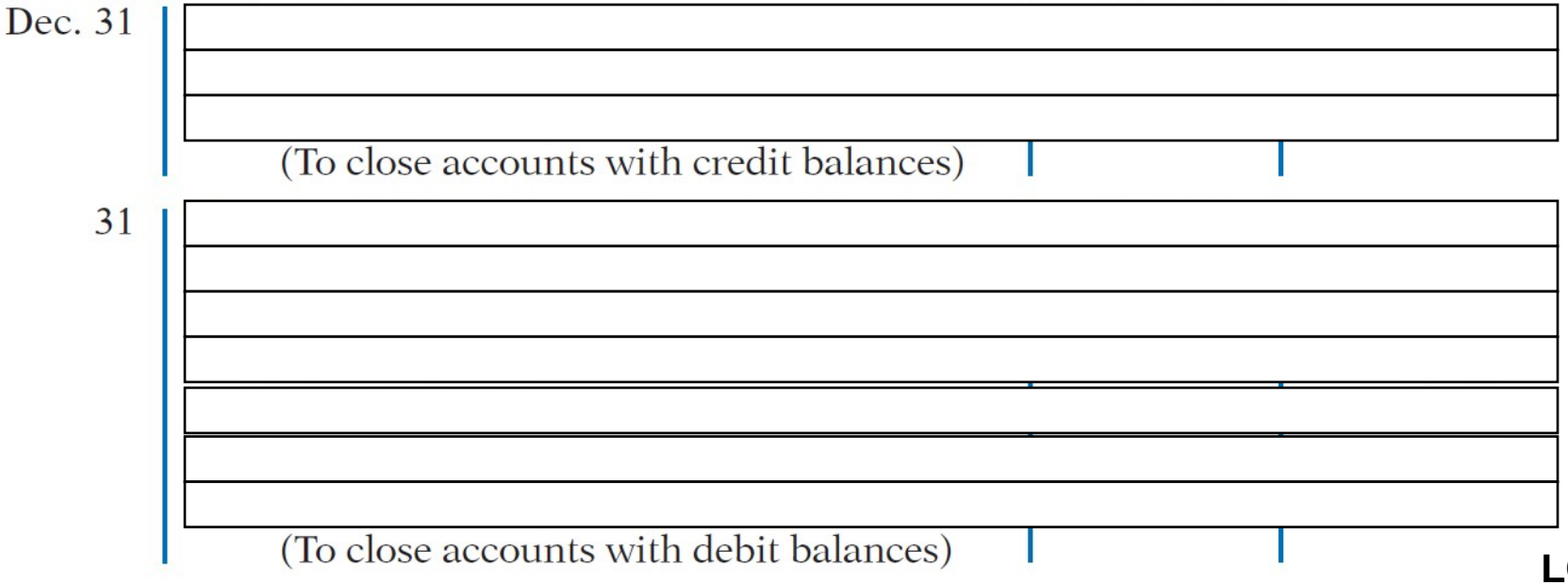
| | | | |
|---|---|---|---|
| 31 | Income Summary | 30,000 | |
| | Retained Earnings | | 30,000 |
| | (To close net income to retained earnings) | | |
| 31 | Retained Earnings | 15,000 | |
| | Dividends | | 15,000 |
| | (To close dividends to retained earnings) | | |



**LO 4 Explain the steps in the accounting cycle for a merchandising company.**

# DO IT!

The trial balance of Celine's Sports Wear Shop at December 31 shows Inventory €25,000, Sales Revenue €162,400, Sales Returns and Allowances €4,800, Sales Discounts €3,600, Cost of Goods Sold €110,000, Rent Revenue €6,000, Freight-Out €1,800, Rent Expense €8,800, and Salaries and Wages Expense €22,000. Prepare the closing entries for the above accounts.






LO 4

# Forms of Financial Statements

## Income Statement

- Primary source of information for evaluating a company's performance.
- Format is designed to differentiate between the various sources of income and expense.



**LO 5 Prepare an income statement for a merchandiser.**

# Forms of Financial Statements

## Income Statement Presentation of Sales

**PW Audio Supply, Inc.**
Income Statement
For the Year Ended December 31, 2014

| | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- **Net sales**

| PW Audio Supply, Inc.<br>Income Statement<br>For the Year Ended December 31, 2014 | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
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| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- Net sales
- **Gross profit**

**PW Audio Supply, Inc.**
Income Statement
For the Year Ended December 31, 2014

| | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
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| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- Net sales
- Gross profit
- **Gross profit rate**

**PW Audio Supply, Inc.**
Income Statement
For the Year Ended December 31, 2014

| | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

| Gross Profit | ÷ | Net Sales | = | Gross Profit Rate |
|---|---|---|---|---|
| €144,000 | ÷ | €460,000 | = | 31.3% |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- Net sales
- Gross profit
- **Operating expenses**

| PW Audio Supply, Inc.<br>Income Statement<br>For the Year Ended December 31, 2014 | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- Net sales
- Gross profit
- Operating expenses
- **Other income and expense**

| PW Audio Supply, Inc.<br>Income Statement<br>For the Year Ended December 31, 2014 | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- Net sales
- Gross profit
- Operating expenses
- **Other income and expense**

| PW Audio Supply, Inc.<br>Income Statement<br>For the Year Ended December 31, 2014 | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |

| Other Income |
|---|
| **Interest revenue** from notes receivable and marketable securities. |
| **Dividend revenue** from investments in ordinary shares. |
| **Rent revenue** from subleasing a portion of the store. |
| **Gain** from the sale of property, plant, and equipment. |
| **Other Expenses** |
| **Casualty losses** from causes such as vandalism and accidents. |
| **Loss** from the sale or abandonment of property, plant, and equipment. |
| **Loss** from strikes by employees and suppliers. |

Illustration 5-14

# Forms of Financial Statements

## Income Statement

**Key Items:**

- Net sales
- Gross profit
- Operating expenses
- Other income and expense
- **Interest expense**

| PW Audio Supply, Inc.<br>Income Statement<br>For the Year Ended December 31, 2014 | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

**Illustration 5-14**

# Forms of Financial Statements

Illustration 5-14

## Income Statement

**Key Items:**

- Net sales
- Gross profit
- Operating expenses
- Other income and expense
- Interest expense
- **Net income**

**PW Audio Supply, Inc.**
Income Statement
For the Year Ended December 31, 2014

| | | |
|---|---|---|
| **Sales revenues** | | |
| Sales revenue | | €480,000 |
| Less: Sales returns and allowances | €12,000 | |
| Sales discounts | 8,000 | 20,000 |
| Net sales | | 460,000 |
| **Cost of goods sold** | | 316,000 |
| **Gross profit** | | 144,000 |
| **Operating expenses** | | |
| Salaries and wages expense | 64,000 | |
| Utilities expense | 17,000 | |
| Advertising expense | 16,000 | |
| Depreciation expense | 8,000 | |
| Freight-out | 7,000 | |
| Insurance expense | 2,000 | |
| Total operating expenses | | 114,000 |
| **Income from operations** | | 30,000 |
| **Other income and expense** | | |
| Interest revenue | 3,000 | |
| Gain on sale of equipment | 600 | |
| Casualty loss from vandalism | (200) | 3,400 |
| Interest expense | | 1,800 |
| **Net income** | | € 31,600 |

# Forms of Financial Statements

## Question

The statement for a merchandiser shows each of the following features except:

a. gross profit.

b. cost of goods sold.

c. a sales revenue section.

d. investing activities section.



**LO 5 Prepare an income statement for a merchandiser.**

# Forms of Financial Statements

## Comprehensive Income

Includes certain adjustments to pension plan assets, gains and losses on foreign currency translation, and unrealized gains and losses on certain types of investments.

**Illustration 5-15**

| | |
|---|---|
| Net income | €31,600 |
| Other comprehensive income | |
| Unrealized holding gain on investment securities | 2,300 |
| Comprehensive income | €33,900 |

Reported in a combined statement of net income and comprehensive income, **or** in a separate schedule that reports only comprehensive income.



**LO 5 Prepare an income statement for a merchandiser.**

# Forms of Financial Statements

## Classified Statement of Financial Position

Illustration 5-16

**PW Audio Supply, Inc.**
Statement of Financial Position (Partial)
December 31, 2014

| | | |
|---|---|---|
| **Assets** | | |
| Property, plant, and equipment | | |
| Equipment | €80,000 | |
| Less: Accumulated depreciation—equipment | 24,000 | € 56,000 |
| Current assets | | |
| Prepaid insurance | 1,800 | |
| **Inventory** | 40,000 | |
| Accounts receivable | 16,100 | |
| Cash | 9,500 | 67,400 |
| Total assets | | €123,400 |



LO 5 Prepare an income statement for a merchandiser.

# DO IT!

You are presented with the following list of accounts from the adjusted trial balance for merchandiser Gorman Company. Indicate in which financial statement and under what classification each of the following would be reported.

| Account | Financial Statement | Classification |
|---|---|---|
| Accounts payable | SFP | Current liabilities |
| Accounts receivable | SFP | Current assets |
| Accumulated Depreciation-Buildings | SFP | Property, plant, and equipment |
| Accumulated Depreciation-Equipment | SFP | Property, plant, and equipment |
| Advertising Expense | IS | Operating expenses |
| Buildings | SFP | Property, plant, and equipment |
| Cash | SFP | Current assets |
| Depreciation Expense | IS | Operating expenses |
| Dividends | RES | Deduction section |

# DO IT!

You are presented with the following list of accounts from the adjusted trial balance for merchandiser Gorman Company. Indicate in which financial statement and under what classification each of the following would be reported.

| Account | Financial Statement | Classification |
|---|---|---|
| Equipment | SFP | Property, plant, and equipment |
| Freight-Out | IS | Operating expenses |
| Gain on Disposal of Plant Assets | IS | Other income and expense |
| Insurance Expense | IS | Operating expenses |
| Interest Expense | IS | Interest expense |
| Interest Payable | SFP | Current liabilities |
| Inventory | SFP | Current assets |
| Land | SFP | Property, plant, and equipment |
| Notes Payable | SFP | Non-current liabilities |



LO 5

# DO IT!

You are presented with the following list of accounts from the adjusted trial balance for merchandiser Gorman Company. Indicate in which financial statement and under what classification each of the following would be reported.

| Account | Financial Statement | Classification |
|---|---|---|
| Property Taxes Payable | SFP | Non-current liabilities |
| Salaries and Wages Expense | IS | Operating expenses |
| Salaries and Wages Payable | SFP | Current liabilities |
| Sales Returns and Allowances | IS | Sales revenue |
| Sales Revenue | IS | Sales revenue |
| Share Capital - Ordinary | SFP | Equity |
| Utilities Expense | IS | Operating expenses |

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Periodic Inventory System

- Record revenues when sales are made.
- Do not record cost of goods sold on the date of sale.
- Physical inventory count determines:
  - Cost of merchandise **on hand** and
  - Cost of goods **sold** during the period.
- Record purchases in Purchases account.
- Purchase returns and allowances, Purchase discounts, and Freight costs are recorded in separate accounts.



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Determining Cost of Goods Sold

Illustration 5A-2

**PW Audio Supply, Inc.**
Cost of Goods Sold
For the Year Ended December 31, 2014

| | | | |
|---|---|---|---|
| Cost of goods sold | | | |
| **Inventory, January 1** | | | **€ 36,000** |
| Purchases | | €325,000 | |
| Less: Purchase returns and allowances | €10,400 | | |
| Purchase discounts | 6,800 | 17,200 | |
| Net purchases | | 307,800 | |
| Add: Freight-in | | 12,200 | |
| **Cost of goods purchased** | | | **320,000** |
| Cost of goods available for sale | | | 356,000 |
| **Less: Inventory, December 31** | | | **40,000** |
| **Cost of goods sold** | | | **€316,000** |



LO 6

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Recording Purchases of Merchandise

**Illustration:** On the basis of the sales invoice (Illustration 5-6) and receipt of the merchandise ordered from PW Audio Supply, Sauk Stereo records the €3,800 purchase as follows.

| | | | |
|---|---|---|---|
| May 4 | Purchases | 3,800 | |
| | Accounts payable | | 3,800 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Freight Costs

**Illustration:** If Sauk pays Haul-It Freight Company €150 for freight charges on its purchase from PW Audio Supply on May 6, the entry on Sauk's books is:

| | | | |
|---|---|---|---|
| May 6 | Freight-in (Transportation-in) | 150 | |
| | Cash | | 150 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Purchase Returns and Allowances

**Illustration:** Sauk Stereo returns €300 of goods to PW Audio Supply and prepares the following entry to recognize the return.

| | | | |
|---|---|---|---|
| May 8 | Accounts payable | 300 | |
| | Purchase returns and allowances | | 300 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Purchase Discounts

**Illustration:** On May 14 Sauk Stereo pays the balance due on account to PW Audio Supply, taking the 2% cash discount allowed by PW Audio for payment within 10 days. Sauk Stereo records the payment and discount as follows.

| | | | |
|---|---|---|---|
| May 14 | Accounts payable | 3,500 | |
| | Purchase discounts | | 70 |
| | Cash | | 3,430 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Recording Sales of Merchandise

**Illustration:** PW Audio Supply records the sale of €3,800 of merchandise to Sauk Stereo on May 4 as follows.

| | | | |
|---|---|---|---|
| May 4 | Accounts receivable | 3,800 | |
| | Sales revenue | | 3,800 |

**No entry is recorded for cost of goods sold at the time of the sale under a periodic system.**



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Sales Returns and Allowances

**Illustration:** To record the returned goods received from Sauk Stereo on May 8, PW Audio Supply records the €300 sales return as follows.

| | | | |
|---|---|---|---|
| May 4 | Sales returns and allowances | 300 | |
| | Accounts receivable | | 300 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Sales Discounts

**Illustration:** On May 14, PW Audio Supply receives payment of €3,430 on account from Sauk Stereo. PW Audio honors the 2% cash discount and records the payment of Sauk's account receivable in full as follows.

| | | | |
|---|---|---|---|
| May 14 | Cash | 3,430 | |
| | Sales discounts | 70 | |
| | Accounts receivable | | 3,500 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Comparison of Entries—Perpetual Vs. Periodic

**Illustration 5A-3**

**Entries on Sauk Stereo's Books**

| | Transaction | Perpetual Inventory System | | | Periodic Inventory System | | |
|---|---|---|---|---|---|---|---|
| May 4 | Purchase of merchandise on credit. | Inventory | 3,800 | | Purchases | 3,800 | |
| | | Accounts Payable | | 3,800 | Accounts Payable | | 3,800 |
| 6 | Freight costs on purchases. | Inventory | 150 | | Freight-In | 150 | |
| | | Cash | | 150 | Cash | | 150 |
| 8 | Purchase returns and allowances. | Accounts Payable | 300 | | Accounts Payable | 300 | |
| | | Inventory | | 300 | Purchase Returns and Allowances | | 300 |
| 14 | Payment on account with a discount. | Accounts Payable | 3,500 | | Accounts Payable | 3,500 | |
| | | Cash | | 3,430 | Cash | | 3,430 |
| | | Inventory | | 70 | Purchase Discounts | | 70 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5A PERIODIC INVENTORY SYSTEM

## Comparison of Entries—Perpetual Vs. Periodic

**Illustration 5A-3**

**Entries on PW Audio Supply's Books**

| | Transaction | Perpetual Inventory System | | | Periodic Inventory System | | |
|---|---|---|---|---|---|---|---|
| May 4 | Sale of merchandise on credit. | Accounts Receivable | 3,800 | | Accounts Receivable | 3,800 | |
| | | Sales Revenue | | 3,800 | Sales Revenue | | 3,800 |
| | | **Cost of Goods Sold** | **2,400** | | **No entry for cost of goods sold** | | |
| | | **Inventory** | | **2,400** | | | |
| 8 | Return of merchandise sold. | Sales Returns and Allowances | 300 | | Sales Returns and Allowances | 300 | |
| | | Accounts Receivable | | 300 | Accounts Receivable | | 300 |
| | | **Inventory** | **140** | | **No entry** | | |
| | | **Cost of Goods Sold** | | **140** | | | |
| 14 | Cash received on account with a discount. | Cash | 3,430 | | Cash | 3,430 | |
| | | Sales Discounts | 70 | | Sales Discounts | 70 | |
| | | Accounts Receivable | | 3,500 | Accounts Receivable | | 3,500 |



**LO 6 Explain the recording of purchases and sales of inventory under a periodic inventory**

# APPENDIX 5B

**Worksheet for a Merchandising Company**

**LO 7 Prepare a worksheet for a merchandising company.**

**PW Audio Supply, Inc.**
**Worksheet**
**For the Year Ended December 31, 2014**

**Illustration 5B-1**

| Accounts | Trial Balance Dr. | Trial Balance Cr. | Adjustments Dr. | Adjustments Cr. | Adjusted Trial Balance Dr. | Adjusted Trial Balance Cr. | Income Statement Dr. | Income Statement Cr. | Statement of Financial Position Dr. | Statement of Financial Position Cr. |
|---|---|---|---|---|---|---|---|---|---|---|
| Cash | 9,500 | | | | 9,500 | | | | 9,500 | |
| Accounts Receivable | 16,100 | | | | 16,100 | | | | 16,100 | |
| Inventory | 40,500 | | | (a) 500 | 40,000 | | | | 40,000 | |
| Prepaid Insurance | 3,800 | | | (b) 2,000 | 1,800 | | | | 1,800 | |
| Equipment | 80,000 | | | | 80,000 | | | | 80,000 | |
| Accumulated Depreciation—Equipment | | 16,000 | | (c) 8,000 | | 24,000 | | | | 24,000 |
| Accounts Payable | | 20,400 | | | | 20,400 | | | | 20,400 |
| Share Capital—Ordinary | | 50,000 | | | | 50,000 | | | | 50,000 |
| Retained Earnings | | 33,000 | | | | 33,000 | | | | 33,000 |
| Dividends | 15,000 | | | | 15,000 | | | | 15,000 | |
| Sales Revenue | | 480,000 | | | | 480,000 | | 480,000 | | |
| Sales Returns and Allowances | 12,000 | | | | 12,000 | | 12,000 | | | |
| Sales Discounts | 8,000 | | | | 8,000 | | 8,000 | | | |
| Cost of Goods Sold | 315,500 | | (a) 500 | | 316,000 | | 316,000 | | | |
| Freight-Out | 7,000 | | | | 7,000 | | 7,000 | | | |
| Advertising Expense | 16,000 | | | | 16,000 | | 16,000 | | | |
| Salaries and Wages Expense | 59,000 | | (d) 5,000 | | 64,000 | | 64,000 | | | |
| Utilities Expense | 17,000 | | | | 17,000 | | 17,000 | | | |
| Totals | 599,400 | 599,400 | | | | | | | | |
| Insurance Expense | | | (b) 2,000 | | 2,000 | | 2,000 | | | |
| Depreciation Expense | | | (c) 8,000 | | 8,000 | | 8,000 | | | |
| Salaries and Wages Payable | | | | (d) 5,000 | | 5,000 | | | | 5,000 |
| Totals | | | 15,500 | 15,500 | 612,400 | 612,400 | 450,000 | 480,000 | 162,400 | 132,400 |
| Net Income | | | | | | | 30,000 | | | 30,000 |
| Totals | | | | | | | 480,000 | 480,000 | 162,400 | 162,400 |

# Another Perspective

## Key Points

- Under both GAAP and IFRS, a company can choose to use either a perpetual or a periodic system.
- Inventories are defined by IFRS as held-for-sale in the ordinary course of business, in the process of production for such sale, or in the form of materials or supplies to be consumed in the production process or in the providing of services. The definition under GAAP is essentially the same.

# Another Perspective

## Key Points

- Under GAAP, companies generally classify income statement items by function. Classification by function leads to descriptions like administration, distribution, and manufacturing. Under IFRS, companies must classify expenses by either nature or by function. Classification by nature leads to descriptions such as the following: salaries, depreciation expense, and utilities expense. If a company uses the functional-expense method on the income statement, disclosure by nature is required in the notes to the financial statements.
- Presentation of the income statement under GAAP follows either a single-step or multiple-step format. IFRS does not mention a single-step or multiple-step approach.

# Another Perspective

## Key Points

- Under IFRS, revaluation of land, buildings, and intangible assets is permitted. The initial gains and losses resulting from this revaluation are reported as adjustments to equity, often referred to as other comprehensive income. The effect of this difference is that the use of IFRS instead of GAAP results in more transactions affecting equity (other comprehensive income) but not net income.
- IAS 1, "Presentation of Financial Statements," provides general guidelines for the reporting of income statement information. Subsequently, a number of international standards have been issued that provide additional guidance to issues related to income statement presentation.

# Another Perspective

## Key Points

- Similar to GAAP, comprehensive income under IFRS includes unrealized gains and losses (such as those on so-called "available-for-sale securities") that are not included in the calculation of net income.
- IFRS requires that two years of income statement information be presented, whereas GAAP requires three years.

# Another Perspective

## Looking to the Future

The IASB and FASB are working on a project that would rework the structure of financial statements. Specifically, this project will address the issue of how to classify various items in the income statement. A main goal of this new approach is to provide information that better represents how businesses are run. In addition, this approach draws attention away from just one number—net income. It will adopt major groupings similar to those currently used by the statement of cash flows (operating, investing, and financing), so that numbers can be more readily traced across statements. For example, the amount of income that is generated by operations would be traceable to the assets and liabilities used to generate the income. Finally, this approach would also provide detail, beyond that currently seen in most statements (either GAAP or IFRS), by requiring that line items be presented both by function and by nature. The new financial statement format was heavily influenced by suggestions from financial statement analysts.

# Another Perspective

## GAAP Self-Test Questions

Which of the following would not be included in the definition of inventory under GAAP?

a) Photocopy paper held for sale by an office-supply store.

b) Stereo equipment held for sale by an electronics store.

c) Used office equipment held for sale by the human relations department of a plastics company.

d) All of the above would meet the definition.

# Another Perspective

## GAAP Self-Test Questions

Which of the following would not be a line item of a company reporting costs by nature?

a) Depreciation expense.

b) Salaries and wages expense.

c) Interest expense.

d) Manufacturing expense.

# Another Perspective

## GAAP Self-Test Questions

Which of the following would not be a line item of a company reporting costs by function?

a) Administration.

b) Manufacturing.

c) Utilities expense.

d) Distribution.

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