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Module 6

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Instructions:

Click on any of the underlined titles in the table of contents to be directed to that section of the module. Click on the <**back**> symbol to return to the table of contents.

Video Lectures

Because seeing and hearing is sometimes better than just reading, I have prepared two video lectures for this module. After you read through the sections below, click here to play or to download the videos:

Merchandising and Inventory Purchases: http://youtu.be/U7c2TpH-so4
Sales Transactions and the Income Statement: http://youtu.be/R-mOtnoH4XY

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Module 6 Summary

I. About Merchandising Businesses

A. ***Merchandising businesses*** include the corner drug store, the local supermarket, and department stores in your neighborhood. All operate in the same way. They purchase ***merchandise inventory*** from their suppliers (either wholesalers or manufacturers), mark the goods up, and sell them for a profit. *Service businesses*, on the other hand, provide services to customers for a fee. Both types of businesses must be able to produce enough revenue from their operations to cover all their expenses and still provide adequate profits for the owner(s). If they cannot, they will be closed down and they will cease to exist.

1. Merchandising businesses include *wholesale* (sales are made to other merchants) and *retail* operations (sales are made to the final consumer).

2. Merchants incur the same expenses that service firms do, but have another expense to cover as well - the cost of the goods that they sell. This expense is called the ***Cost of Goods Sold***, ***Cost of Merchandise Sold***, or the ***Cost of Sales***.

3. The merchant's motto is *buy low, sell high*. Every merchant must be able to buy goods at a relatively low price, mark them up, and then sell them "high" enough to provide for a reasonable profit from operations. The revenue from sales must cover the cost of the merchandise sold along with all the other expenses of operating the business.

B. When merchandise is purchased for resale, the cost of the merchandise is recorded in a ***Merchandise Inventory*** asset account.

1. Only goods that were purchased with the intent to resell them to customers can be recorded in the *Merchandise Inventory* asset account. Old equipment or unneeded supplies that were once used in operations and are now for sale do not represent merchandise inventory items.

2. Many costs are associated with the purchase of inventory, but only (1) the *costs that <u>had to be incurred</u> in order to acquire the inventory*, or (2) *costs incurred in <u>readying the inventory for sale</u>*, can be included as part of the cost of the inventory. This is an

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important distinction, since costs that cannot be included in the inventory account balance will have to be "expensed." That is, they will be recorded as current period expenses and will appear on the period's income statement. Costs that can be "inventoried" (that is, be recorded in the *Merchandise Inventory* asset account and reported on the balance sheet) will not affect net income until later, when they are sold.

Helpful Hint. *It can be confusing at first to decide whether a given cost should be expensed or inventoried. Just ask yourself the following question: "If this cost had not been incurred, would I have the inventory out on the sales floor ready to sell to the customers?" If the answer is "no," then the cost is inventoriable.*

Here's an example. Suppose Fred's Bicycle Shop orders 100 bicycles from a supplier, agreeing to pay $30,000. Fred also agrees to pay the freight charges of $500. When the bicycles arrive at the railroad terminal, Fred pays a local trucking company $100 to pick up the bicycles and deliver them to his place of business. When the crates arrive, Fred pays a team of workers a total of $2,000 to unbox the bicycles, assemble them, and set them up on the racks on the sales floor. During the assembly process a forklift driver accidentally drives the forklife through a wall. The cost to repair the wall is $1,000. Fred then pays the local newspaper $50 to advertise the big bicycle sales event.

Which of these costs should be recorded as operating expenses, and which of the costs are "inventoriable?"

Answer: The $30,000 invoice cost, the $500 railroad shipping cost, and the $100 delivery fee are all inventory costs. So is the $2,000 assembly cost. These costs were necessary in order to acquire the bicycles and ready them for sale. Without them, Fred would have no bicycles in his shop ready for sale to his customers!

The $1,000 repair to the wall and the $50 advertising bill are both operating expenses. The damage to the wall did not have to occur in order to assemble the bikes; and the advertising cost was incurred in order to sell the bicycles, not to acquire them and ready them for sale. Had these costs not been incurred, Fred would still have the bicycles on the sales floor, ready to be sold.

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C. The ***operating cycle*** for a merchant is composed of the following steps: (1) purchase the inventory, (2) sell the inventory, and (3) collect the cash from the sale. If sales are made on account and collection is delayed, or if inventory is hard to sell in the first place, the operating cycle may take months to complete. However, it often takes only a few weeks. Therefore, the asset account, *Merchandise Inventory*, will almost always be classified as a *current asset*.

D. Uncertainties regarding cash receipts from sales make ***cash flow management*** an important function for merchants. Having adequate cash on hand at all times is necessary in order to avoid insolvency and ensure liquidity. Pricing decisions, the selection of products and suppliers,

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and control over expenses (the three functions together are termed ***profitability management***) are also crucial factors in merchandising, as are the development of systems and procedures to guard against theft of inventory and embezzlement of cash (the ***internal control structure***).

Video Lecture
This video lecture contains the same information that is presented below. Read the section below first, but then click here to play the video.

Sales Transactions and the Income Statement: **http://youtu.be/R-mOtnoH4XY**

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II. Accounting for Sales

A. Merchants earn revenue when merchandise inventory items are sold to customers. The account used to record revenue from the sale of merchandise inventory is called ***Sales***.

B. Revenue is normally recognized when legal title to the goods passes from the seller to the buyer. This usually occurs at the *point of sale*, when the buyer takes physical possession of the goods and carries them away.

1. If cash is received at the time of the sale, the entry to record the revenue is as follows:

Cash	***$X***	
Sales		***$X***

2. Sales can also be made "on account," or on credit terms. When credit sales are made, the customer is allowed to take the merchandise and is then given a number of days (often 30) in which to pay. Since title has passed to the customer, the sales revenue is recorded. The entry is as follows:

Accounts Receivable	***$X***	
Sales		***$X***

C. Sales revenue may be affected by ***sales returns*** and ***sales allowances***.

1. ***Defective merchandise*** is sometimes sold to a customer, though every merchant attempts to prevent this from happening. It is costly for the merchant to process merchandise returns, and customers

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might even decide to shop elsewhere if they associate the defects with the merchant and not the manufacturer.

2. The merchant must establish a policy regarding returns, and most will be rather generous. After all, the customer is already upset about the defective goods, and the merchant will often “bend over backwards” to make amends and create a favorable impression with the customer.

3. Merchants usually allow defective goods to be returned, and will refund the sales price to the customer. This is called a ***sales return***. After the merchandise is taken back, the merchant then attempts to return the defective goods to the wholesaler or manufacturer. This is a time-consuming and costly process; and the merchant may not always be successful in getting compensation from the supplier. Sometimes, the merchant is “stuck” with the goods, and has to “clearance” them out at “damaged goods” prices. (This is why it is important to select a reputable supplier and then maintain a good business relationship with that supplier).

4. If the merchant knows that it will be difficult to return a defective product to the supplier, or if the defect is minor, the merchant might offer the customer an *allowance* against the purchase price. This reduction in sales price is called a ***sales allowance***. A portion of the sales price is refunded to the customer (or the customer’s account balance is reduced), and the customer keeps the defective merchandise.

5. When returns and allowances occur, the customer's account balance (or the Cash account) is credited. The amount of sales revenue reported on the income statement must also be reduced, since the sale that was recorded is now being canceled. However, the *Sales* account is not debited to record these transactions. Instead, both returns and allowances are debited to the same account, ***Sales Returns and Allowances***.

    a. ***Sales Returns and Allowances***, a contra-revenue account (it is contra to the *Sales* account), and it has a normal debit balance. It is subtracted from the *Sales* account balance on the income statement.

    b. Returns and allowances are recorded at the time the goods are returned or the allowance is granted. The form of the entry is as follows:

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Sales Returns & Allowances **$X**
  Accounts Receivable (or Cash) **$X**

(Note: If a perpetual inventory system is being used, it is also necessary to record a return by debiting the Merchandise Inventory account. This is explained in the section below regarding perpetual inventory systems.)

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Why is a contra-account used? Why not just debit *Sales*? Well, it is true that if the *Sales* account is directly debited, the account balance will be reduced and a lesser amount of sales will be reported on the income statement. *But then an income statement user will never be able to tell that the return or allowance occurred!* The transaction will be "buried" inside the Sales account.

Using the contra-account allows the accountant to record the returns and allowances separately, and to report them separately on the income statement. The revenue section of the income statement will look like so:

Revenue		
Sales		***$X***
Less Sales Returns & Allowances	***(X)***	***$X***

It is important for the merchant to know how much sales revenue is being "lost" to returns and allowances. This information is also relevant information for investors. Using the contra-account allows the accountant to disclose this important information on the fact of the statement for all to see.

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C. ***Sales discounts*** (or *cash discounts*) also affect sales revenue. Sales discounts are reductions in invoice price that are given for early payment of the balance due. They would only apply to sales made on account, and are offered for two reasons: (1) they improve customer relations (everyone likes a "deal"), and (2) they encourage early payment (which shortens the merchant's operating cycle and improves cash flow and liquidity).

1. Discounts are normally 1 to 3% of the invoice price, and are stated in the ***terms of sale*** that are printed on the invoice. The *terms* are stated in an abbreviated form that is difficult to understand at first. Terms of "2/10, n30" are interpreted as follows: "*The invoice price,* ***net*** *(that's the "n") of any allowances that might be granted, is due in* ***30*** *days; but a* ***2%*** *discount can be taken off the invoice price if payment is may within* ***10*** *days*."

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2. If early payment is made and the discount is taken, it will be recorded in a ***Sales Discounts*** account when the cash collection is recorded.

3. ***Sales Discounts*** is another contra-revenue account with a normal debit balance. It is used for the same reason that *Sales Returns and Allowances* is used. It allows the amount of the discounts taken by the customers to be accumulated and reported separately on the income statement. Again, this is relevant information for users of the statement to see.

4. Sales discounts are recorded at the time the customer's payment is received. When the customer qualifies for a sales discount, the amount of cash the customer pays will be less than the balance in the customer's account. The difference will be equal to the amount of the discount. The entry is:

Cash	***$X***	
Sales Discounts	***$X***	
Accounts Receivable		***$X***

5. On the income statement, the *Sales* account balance is reported along with *Sales Discounts* and *Sales Returns and Allowances*. These two accounts are subtracted from *Sales* to determine ***net sales***, the amount for which the sale was actually made:

Revenues:		
Sales		***$X***
Less: Sales Discounts	***$X***	
Sales Returns and Allowances	***+X***	***(X)***
Net Sales		***$X***

D. When goods have to be shipped to the buyer, the party responsible for paying the ***freight charges*** will be specified in the terms of sale. If the terms are ***FOB Destination*** ("*free on board, to the destination*") the seller agrees to pay the freight all the way to the buyer's address. These freight charges represent an expense incurred by the seller in order to make the sale, so they are classified as an operating expense. They are recorded in an account that is sometimes called ***Freight Out*** or ***Transportation Out***. This account might better be called "***Delivery Expense***," since that is what it represents. It is listed on the income statement along with the other operating expenses.

Delivery Expense (or ***Freight-Out*** or ***Transportation-Out)***	***$X***	
Accounts Payable (or ***Cash)***		***$X***

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III. Periodic and Perpetual Inventory Systems

A. A merchant may account for *Inventory* and the *Cost of Goods Sold* using either a ***periodic*** or a ***perpetual*** inventory system.

B. ***Perpetual systems*** are named as they are because the inventory account is perpetually (continually) adjusted for purchases or sales. As inventory is purchased and sold, the *Merchandise Inventory* account is debited and credited. Therefore, the account balance is always current and correct.

C. *Periodic* systems are so named because the inventory account is only adjusted at the end of the accounting period (that is, "periodically").

1. Under a periodic system, the Merchandise Inventory account is not debited or credited when purchases or sales occur; instead the beginning inventory account balance remains in the account until the end of the accounting period. The account is then adjusted and the correct balance is established.

2. A detailed presentation of the process of accounting for purchases and sales of merchandise under a periodic inventory system is not presently included in our tutorials. Stay tuned, though. At some point it will be added. Let me know if it is important to you, and I'll try to add it sooner rather than later.

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Attention accounting masochists! *At the end of the section below you will find a practice problem with a solution provided. After that, in the supplement at the end of the module, you will find another practice problem that you are encouraged to work on your own (and without looking at the solution!) Remember that it is necessary to practice accounting in order to learn accounting, so prepare yourself. Straighten your back, grit your teeth, and suffer through both practice problems! (And enjoy the experience! :)*

When you read the transaction descriptions, think about them and determine what entry is required before you look at the solutions to the problems. Remember, it is the motivated masochist who excels in the field and grabs the biggest brass ring. Study hard and study to learn. Wax on, wax off!

IV. Perpetual Inventory Systems

A. *Accounting for Inventory Purchases and Sales*

1. As we know, under a perpetual inventory system, the ***Merchandise Inventory*** account is debited or credited each

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time a purchase, sale, or return occurs. All these transactions affect the inventory balance and so require an entry.

2. ***Purchases*** of merchandise from a supplier are recorded when legal title to the goods acquired passes to the merchant. This is normally at the point of sale, when the merchant takes physical possession of the goods.

   a. In a perpetual system, ***purchases*** are recorded as follows:

Merchandise Inventory	***$X***	
Accounts Payable (or Cash)		***$X***

   b. Since inventory is continually adjusted in a perpetual system, ***Sales*** are recorded as follows:

Accounts Receivable (or ***Cash)***	***$X***	
Sales		***$X***
Cost of Merchandise Sold	***$X***	
Merchandise Inventory		***$X***

3. ***Trade discounts*** may be offered to a merchant by a supplier. The supplier's catalog of items usually lists a "manufacturer's suggested retail selling price" (*MSRP*, or *list price*) with the items. This is always an inflated price, and no one expects that they will actually have to pay "list price" for the items. The merchant contacts the wholesaler or manufacturer and is granted a *trade discount*. The merchant applies the trade discount to the MSRP, and pays the discounted price for the goods. Therefore, trade discounts merely serve to determine the actual price that must be paid for the goods. *No entries are ever made to record trade discounts*.

4. The cost of the inventory purchases that are debited to the *Merchandise Inventory* account may be affected by ***purchases returns and allowances***, by ***purchases discounts*** for early payment (this is just a sales discount offered by the seller that is taken by the buyer), or by ***freight charges*** the merchant paid for delivered merchandise.

   a. As we said earlier, defective goods may be returned to the supplier (or an allowance against the purchase price may be received from the supplier) after the purchase is recorded.

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b. If ***purchase returns or allowances*** occur, the *Accounts Payable* account must be reduced if payment has not yet been made, or *Cash* must be debited if the payment has been made. Since the inventory has been returned (a purchase return) or its cost has been reduced (a purchase allowance), *both purchase returns and purchase allowances are recorded by reducing the inventory account balance*:

Accounts Payable (or Cash)	***$X***	
Merchandise Inventory		***$X***

c. ***Purchases discounts*** are recorded similarly. This is simply a sales discount (as discussed earlier), but one that is offered by the supplier to the merchant. Since we are now recording the discount on the buyer's books rather than the seller's, we refer to them as *purchases discounts*.

Purchases discounts reduce the cost of the inventory, and they are recorded at the time payment is made. The form of the entry is as follows:

Accounts Payable	***$X***	
Merchandise Inventory		***$X***
Cash		***$X***

d. Note that a ***sales allowance*** granted to a customer because of defects *does not affect the inventory account*. This is because items are not returned to the merchant, and there is nothing to put back into the *Merchandise Inventory* account. However, a ***sales return*** *does affect the inventory account*, since items that were previously recorded as sold turn out to have not been sold after all. The entry to record a sales return is:

Sales Returns and Allowances	***$X***	
Accounts Receivable (Cash)		***$X***

Merchandise Inventory	***$X***	
Cost of Merchandise Sold		***$X***

e. ***Freight charges*** for merchandise purchased from a supplier are paid by the merchant when the terms are "***FOB shipping point***" (free on board – but only at the shipping point, and not all the way to the destination). They represent

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an additional cost incurred to acquire the inventory, and therefore should be added to the cost of the inventory when they are paid. The entry is:

Merchandise Inventory	***$X***	
Cash (or Accounts Payable)		***$X***

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V. *Comprehensive Illustration – Perpetual Inventory, Part I*

This illustration “walks you through” and exercise in which entries are made to record the merchandising transactions that were discussed in the sections above. In part II of the illustration, we will prepare statements and journalize the closing entries. A similar comprehensive practice exercise attached as a supplement at the end of this module. Remember that it is necessary to practice accounting in order to learn accounting. As you read through this section, try to determine what entry is required before you look at the entry provided. Practice, practice, practice!

Selected transactions from a merchant’s records are given below. Make general journal entries to record each of the transactions.

	Date	Transaction
(a)	9/1:	The merchant began operations by purchasing inventory items from Bailey Supply House, MSRP $10,000, terms 1/10, n30 f.o.b. shipping point. A 20% trade discount was granted to the merchant by the supplier on this purchase.

Merchandise Inventory	***8,000***	
Accounts Payable		***8,000***

Explanation: The trade discount reduces the purchase price by $2,000, making the cost to the merchant $8,000. Trade discounts are never recorded. The terms indicate that the purchase was made “on account,” and that a 1% discount can be taken if the invoice is paid within 10 days (by September 11). Otherwise, the full amount of the invoice, net of allowances, is due in 30 days (on October 1). FOB shipping point means that the merchant will have to pay the freight charges.

(b)	9/2:	The merchant paid freight charges for the Sept. 2 purchase of $150.

Merchandise Inventory	***150***	
Cash		***150***

Explanation: According to the terms of sale, the merchant must pay the freight charges. They are, then, a necessary cost that is incurred in order to obtain the inventory items, so they are added to the inventory account balance. As explained above, freight charges on purchased inventory items are an “inventoriable” cost.

(c)	9/3:	The merchant returned merchandise that had cost $600 to Bailey Supply House.

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Accounts Payable **600**
Merchandise Inventory **600**

Explanation: Since the merchant no longer owns the inventory, the Merchandise Inventory account balance must be reduced. Payment hasn't been made yet, so the balance in Accounts Payable has to be reduced as well.

(d) 9/4: The merchant discovered additional defects with the merchandise, and the supplier granted the merchant an allowance of $400 against the purchase price. Accepted the price reduction and kept the merchandise.

Accounts Payable **400**
Merchandise Inventory **400**

Explanation: The allowance is recorded in exactly the same way as the merchandise return, even though the transactions are very different. The merchant still owns the inventory items, and still has them for sale. However, the cost of the inventory has been reduced, so the balance in the Merchandise Inventory account balance must be reduced as well. Payment hasn't been made yet, so the balance in Accounts Payable is debited (decreased) when the inventory account is credited (decreased).

(e) 9/15: The merchant paid Bailey Supply House for the items purchased, less the return, not taking the cash discount.

Accounts Payable **7,000**
Cash **7,000**

Explanation: Since payment is now being made, the $7,000 balance in Accounts Payable ($8,000 – 600 - 400 = $7,000) must be reduced to zero. The Cash account is also reduced to record the payment. In this case, the purchase discount (1% x $7,000 = $70) cannot be taken, since payment was not made within 10 days of the invoice date.

What if? *In the example above, the merchant did not take the offered purchase discount. What if the merchant paid the invoice on September 11 and did take the 1% discount? How would the entry have been recorded?*

Accounts Payable **7,000**
Merchandise Inventory **70**
Cash **6,930**

Accounts Payable is again reduced to zero, but only $6,930 of cash is paid to the supplier. The $70 discount represents a reduction in inventory cost. Therefore, in accordance with the cost principle, the balance in the Merchandise Inventory account must be reduced by this $70. The remaining balance in Merchandise Inventory is now $6,930, equal to the net cost of the goods that were added to the inventory through this set of transactions. Note that the purchase discount cannot be taken on the freight charges. The terms specified a 1% discount on the invoice total, which does not include the freight charges that were paid when the merchandise arrived.

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(f) 9/16: Sold construction materials to Jerry Jacks Construction Company for $6,000, terms 2/10, n30 f.o.b. destination. Determined that these materials had cost $3,000.

Accounts Receivable	***6,000***	
Sales		***6,000***

Cost of Goods Sold	***3,000***	
Merchandise Inventory		***3,000***

Explanation: When the perpetual inventory system is used, two entries are required in order to record a sale. The first records the revenue earned from the sale of merchandise in the merchant's revenue account, "Sales." The second reduces the inventory account and records the loss of the inventory assets as an expense.

The terms of sale indicate that this sale was made on account, so "Accounts Receivable" is increased along with "Sales." Legal title to the merchandise has passed to the customer, and if the merchant no longer owns the inventory then the balance in "Merchandise Inventory" must be reduced. This reduction in the merchant's assets occurred in order to earn the sales revenue, and it represents an expense called the "Cost of Goods Sold." We debit this expense account when we credit the inventory account. Note that "Cost of Sales," "Cost of Merchandise Sold," or other titles could also be used for this expense account.

(g) 9/17: Paid shipping charges of $100 from the Sept. 16 sale.

Delivery Expense	***100***	
Cash		***100***

Explanation: Freight charges paid on sales to customers (required if terms are FOB destination) are not an inventoriable cost. Why? Because this payment was made in order to complete the sale, not to acquire the inventory and ready it for sale. The "Delivery Expense," "Freight-Out," or "Transportation-Out" accounts (any of these account titles might be used here) are operating expense accounts. They are similar in nature to advertising, sales clerk's salaries and other marketing costs, and they will be classified as Selling Expenses on the classified income statement.

(h) 9/20: Jerry Jacks Construction Company complained that the materials were not the correct size and returned $200 worth of them. The goods had cost the merchant $100.

Sales Returns and Allowances	***200***	
Accounts Receivable		***200***

Merchandise Inventory	***100***	
Cost of Goods Sold		***100***

Explanation: Two entries are required here. The first reduces the customer's account balance and reduces the sales revenue that will reported on the income statement (the Sales Returns and Allowances account is a contra-account to Sales). The second puts the goods that were returned back into the Merchandise Inventory (with a debit) and reduces the Cost of Goods Sold account (since the goods were not sold after all). Note that company might have "Cost of Merchandise Sold" or "Cost of Sales" in its chart of accounts, instead of "Cost of Goods Sold."

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(i) 9/21: Jerry Jacks Construction Company complained again about other defects in the remaining materials, but agreed to keep them if $300 was taken off the account balance. The merchant approved the price reduction.

Sales Returns and Allowances	**300**	
Accounts Receivable		**300**

Explanation: This time the customer was granted an "allowance" (a price reduction) because of the defects. The transaction is very similar to the previous one, except that the defective goods were not returned to the merchant. Therefore, only one entry is required. Sales Returns and Allowances is debited again, and the customer's account balance is credited. This reduces the sales revenue that will reported on the income statement (the Sales Returns and Allowances account is a contra-account to Sales), and reduces Jerry Jacks' account balance.

9/30: Jerry Jacks Construction Company paid its account, less the return, not taking the cash discount.

Cash	**5,500**	
Accounts Receivable		**5,500**

Explanation: Since payment is now being received, the $5,500 balance in Accounts Receivable ($7,000 – 200 - 300 = $6,500) must be reduced to zero. The Cash account is increased to record the collection. In this case, the sales discount (2% x $5,500 = $110) cannot be taken, since the customer did not pay within 10 days of the invoice date.

What if? *In the example above, Jerry Jacks did not take the offered sales discount because payment was not made within 10 days of the invoice date. What if Jerry paid on September 26 and did take the discount? In that case, the entry would have been recorded like so:*

Cash	**5,390**	
Sales Discounts	**110**	
Accounts Receivable		**5,500**

The Cash account is increased to record the collection, but this time by only $5,390. The sales discount (2% x $5,500 = $110) is recorded in the contra-account "Sales Discounts," and the customer's account balance is reduced to zero. cannot be taken, since the customer did not pay within 10 days of the invoice date.

9/30: Post the journal entries to the Merchandise Inventory, Cost of Goods Sold, Sales, and Sales Returns and Allowances general ledger accounts.

Merchandise Inventory		Cost of Goods Sold		Sales		Sales Returns and Allowances	
Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
a. 8,000	c. 600	f. 3,000	h. 100		f. 6,000	h. 200	
b. 150	d. 400					i. 300	
h. 100	f. 3,000						
bal. 4,250		bal. 2,900			bal. 6,000	bal. 500	

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VI. Single-Step & Multiple-Step Income Statements

A. When preparing a ***single-step income statement***, all the revenue items are added together to determine total revenues, all expenses are added up to determine total expenses, and then the total expenses are subtracted from total revenues (in one *single step*) to calculate net income. This is the income statement format that we have used up to this point in our tutorials. The form of a merchant's single-step income statement is illustrated below:

Single-Step Income Statement
(Perpetual Inventory System)

Revenues:		
Net Sales	$X	
Other Revenues	+X	
Total Revenues		= $X
Expenses:		
Cost of Merchandise Sold	$X	
Selling Expenses	+X	
General & Administrative Expenses	+X	
Other Expenses	+X	
Total Expenses		= (X)
Net Income		= $X

B. In this module we will begin using a new format, a ***multiple-step income statement***. The *Revenues* section of this income statement contains only the *Sales*, the *Sales Discounts* and the *Sales Returns and Allowances* accounts. Any other revenues are reported at the bottom of the statement in the "*Other Income and Expenses*" section. This is done so that when the cost of goods sold is subtracted from net sales, the resulting *gross profit* figure represents only the profit the firm made from the sale of its goods. If other revenues were added to sales, the gross profit figure would be overstated and investors would think that the company's gross profit from sales (its markup) is greater than it actually is.

C. In a multiple-step income statement, *Cost of Merchandise Sold* is presented in a separate section of the statement, directly beneath *Net Sales Revenue*. This allows us to subtract *Cost of Merchandise Sold* from *Net Sales* to determine *Gross Profit*, the profit the seller made from the sale of the goods before all the other expenses incurred operating the business are subtracted. Note that gross profit is also called *gross margin*, and it represents the company's total *markup*. Markup is the amount that the merchant adds on to the cost of an inventory item in order to determine the item's selling price).

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D. The ***Operating Expenses*** are listed below *Gross Profit*, and they are subtracted to determine ***Income from Operations***. The *operating expenses* are those incurred in the normal operations of the business. They are classified as either ***Selling Expenses*** (such as advertising, store rent, sales clerk's wages, and other costs incurred in making sales of the inventory) or as ***General and Administrative Expenses*** (the "back room" costs incurred in running the business such as insurance, bookkeeping, and other costs).

E. *Total operating expenses* are subtracted from *gross profit* to arrive at ***Income from Operations***, the income earned from regular, ongoing business operations.

F. A section for ***Other Revenues and Expenses*** is placed at the bottom of the statement, beneath *Income from Operations*. Any "other" revenues or expenses not yet listed on the income statement are now added or subtracted from *Income from Operations* to determine *Net Income*.

F. Since several different profit figures are calculated in determining the final bottom-line net income, this kind of income statement requires "multiple steps." The form of the ***classified, multiple-step income statement*** under a perpetual inventory system is illustrated below.

Multiple Step Income Statement
(Perpetual Inventory System)

Sales	$X	
Cost of Goods Sold	(X)	
Gross Profit		= $X
Operating Expenses:		
Selling Expenses	$X	
Gen. & Admin Expenses	+X	
Total Operating Expenses		= (X)
Income from Operations		= $X
Other Income and Expense:		
Other Revenues	$X	
Other Expenses	(X)	= $X
Net Income		= $X

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Video Lecture
This video lecture contains the same information that is presented in this module. You should read first, but click here to play the video when you are ready.

Sales Transactions and the Income Statement: http://youtu.be/R-mOtnoH4XY

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VII. *Comprehensive Illustration, Part II*

This is a continuation of the illustration above. We will now prepare the month-end multiple-step income statement. Our merchant's end-of-month account balances are as follows (the income statement accounts are highlighted).

Trial Balance			
Account Number	Account	Debit	Credit
100	Cash	2,000	
110	Accounts Receivable	0	
120	Merchandise Inventory	4,250	
130	Building	11,000	
131	Accumulated Depreciation, Building		1,000
200	Accounts Payable		0
300	John Merchant, Capital		14,250
310	John Merchant, Drawing	0	
400	Sales		6,000
410	Interest Revenue		400
500	Cost of Goods Sold	2,900	
510	Sales Returns and Allowances	500	
520	Delivery Expense	100	
530	Sales Supplies Expense	150	
540	Advertising Expense	50	
550	Bookkeeping Wages Expense	200	
560	Depreciation Expense – Office Equipment	120	
570	Office Supplies Expense	180	
580	Interest Expense	200	
	Total	21,650	21,650

9/30: The merchant posted the September journal entries to the general ledger accounts, balanced them, and prepared the trial balance shown above. Expenses properly classified as selling expenses include Delivery Expense, Sales Supplies Expense, and Advertising Expense. Administrative expenses include Bookkeeping Wages Expense, Depreciation Expense – Office Equipment, and Office Supplies Expense.

Required: Prepare the multiple-step income statement for the month ended September 30.

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Multiple Step Income Statement **For the month ended September 30, 20XX**			
Sales		$6,000	
Less: Sales Returns and Allowances		(500)	
Net Sales			$5,500
Cost of Goods Sold			(2,900)
Gross Profit			$2,600
Operating Expenses:			
Selling Expenses:			
Delivery Expense	$100		
Sales Supplies Expense	150		
Advertising Expense	50		
Total Selling Expenses		$300	
General & Administrative Expenses:			
Bookkeeping Wages Expense	200		
Depreciation Expense – Office Equipment	120		
Office Supplies Expense	180		
Total General & Administrative Expenses		500	
Total Operating Expenses			(800)
Income from Operations			$1,800
Other Income and Expense:			
Interest Revenue	$400		
Interest Expense	(200)		
Total Other Expense			200
Net Income			$2,000

Note that Interest Revenue and Interest Expense are listed under "Other Income and Expense." These items are non-operating revenues and expenses. After all, interest revenue is not related to the merchant's primary operations (buying and selling merchandise) and interest expense is a financing cost, not an operating cost.

VIII. *Other Topics Related to Merchandising Accounting*

A. ***Legal title***. Purchases of inventory items should only be recorded if legal title (ownership) has passed to the merchant. A sale should also be recorded only when legal title has passed to the customer. Legal title passes to the buyer *at the shipping point* when the terms are *FOB*

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shipping point; and *at destination* when the terms are *FOB destination*. Here is a summary of these points:

Legal Title and Terms of Sale		
Merchandise Purchases		
Terms of Sale:	Legal title passes to merchant and purchase can be recorded:	Party who pays freight charges:
FOB shipping point	*When goods are shipped*	*Merchant*
FOB destination	*When goods arrive*	*Supplier*
Merchandise Sales		
Terms of Sale:	Legal title passes to customer and sale can be recorded:	Party who pays freight charges:
FOB shipping point	*When goods are shipped*	*Customer*
FOB destination	*When goods arrive*	*Merchant*

Remember, *the entry to record a sale or a purchase should not be made until legal title has passed to the buyer.*

B. ***Sales Taxes*** may be levied by state or local governments. This tax is charged against the customer who buys a taxable item from the merchant, but the merchant must collect the tax from the customer when the sale is made and forward it on to the taxing body at the appropriate time. In other words, the merchant functions as the "tax collector."

1. When a sale is made, the entry to record the sale and the collection of the tax is:

	Debit	Credit
Cash (or Accounts Receivable)	***$X***	
Sales Tax Payable		***$X***
Sales		***$X***

2. When the tax is paid to the taxing body, the entry is:

	Debit	Credit
Sales Tax Payable	***$X***	
Cash		***$X***

C. If the merchant has registered with a credit card issuer, ***credit cards*** may be used by customers to pay for items. Acceptance of credit cards allows a business to extend credit terms to the customer while shifting the administrative, financing, and uncollectible accounts expenses associated with credit sales to the credit card company.

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1. A fee of 2 to 6% of the gross amount of the sale is charged to compensate the credit card company for these costs. If, as is often the case with VISA and Mastercard sales, the firm is able to deposit its credit card receipts directly at the bank as a cash deposit, the sale can be recorded as a simple cash sale, by debiting Cash and crediting Sales. However, when the 2% to 6% fee is paid to the card issuer, it is necessary to record *Credit Card Expense*:

Cash	***$X***	
Sales		***$X***
Credit Card Expense	***$X***	
Cash		***$X***

2. If, as is the case with American Express and some other credit cards, the firm must submit its sales receipts to the credit card company for reimbursement, *Cash* cannot be debited when the sale is recorded. Instead, a receivable account must be established. The receivable is recorded at gross sales price and the credit card expense is accounted for when payment is received from the credit card company:

Accounts Receivable: Credit Card Company	***$X***	
Sales		***$X***
Cash	***$X***	
Credit Card Discount Expense	***$X***	
Accounts Receivable: Card Company		***$X***

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IX. Worksheets for the Merchandiser are prepared in the same way and for the same reasons that they are prepared for service firms.

A. Since the merchant's general ledger includes the *Inventory* account and a *Cost of Merchandise Sold* account, these accounts must be included in the worksheet. Also, the *Sales*, *Sales Returns and Allowances*, and *Sales Discounts* accounts must be entered on the worksheet and listed in the income statement columns. The inclusion of these new accounts represent the only differences between a service firm's worksheet and the merchant's worksheet.

B. Under a perpetual inventory system, it is only necessary to include the *Inventory* account among the assets listed on the trial balance and the

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Cost of Merchandise Sold account among the expenses. The worksheet is completed as it was for a service firm, with the addition of the *Cost of Merchandise Sold*, *Sales Returns and Allowances*, and *Sales Discounts* accounts in the worksheet's Income Statement debit column; and the *Inventory* account in the worksheet's Balance Sheet debit column.

X. Closing Entries for Merchants

A. Closing entries are very simple for a merchant who uses a perpetual inventory system, and they are nearly identical to those performed for service firms (see Module 4). The only new items are the *Cost of Merchandise Sold, Sales Returns and Allowances,* and *Sales Discounts* accounts (which will be closed along with the other expense accounts into Income Summary). The *Sales* account is closed just as any other revenue account would be.

B. *Sales* and any other revenue accounts will be closed into *Income Summary*.

Sales	***$X***	
Other Revenue	***$X***	
Income Summary		***$X***

C. *Sales Returns and Allowances* and *Sales Discounts*, since both have debit balances, will be closed into *Income Summary* along with the expense accounts.

Income Summary	***$X***	
Sales Returns and Allowances		***$X***
Sales Discounts		***$X***
Cost of Merchandise Sold		***$X***
Selling Expenses		***$X***
General & Administrative Expenses		***$X***
Other Expenses		***$X***

C. A that remains now is to close the balance of *Income Summary* (which should be equal to the net income or loss figure for the period), and the balance of the *Drawing* account, into *Capital*:

Income Summary	***$X***	
Capital		***$X***
Capital	***$X***	
Drawing		***$X***

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XI. *Comprehensive Illustration, Part III*

This concludes the illustration problem. We are now ready to prepare the month-end closing entries for our merchant.

9/30: The merchant journalized the closing entries for the month ended September 30.

(1) The *Sales* account is closed to *Income Summary*, along with *Interest Revenue*:

Account	Debit	Credit
Sales	***6,000***	
Interest Revenue	***400***	
Income Summary		***6,400***
To close the revenue accounts		

(2) *Sales Returns and Allowances* and *Cost of Goods Sold* (both have debit balances) will be closed into *Income Summary* along with the other expense accounts.

Account	Debit	Credit
Income Summary	***4,400***	
Sales Returns and Allowances		***500***
Cost of Goods Sold		***2,900***
Delivery Expense		***100***
Sales Supplies Expense		***150***
Advertising Expense		***50***
Bookkeeping Wages Expense		***200***
Depreciation Expense – Office Equip.		***120***
Office Supplies Expense		***180***
Interest Expense		***200***
To close the contra-revenue and expense accounts		

(3) The balance of *Income Summary* (which should be equal to the net income or loss figure for the period) is closed into the *Capital* account, and then the *Drawing* account is closed into *Capital*:

Account	Debit	Credit
Income Summary	***2,000***	
Capital		***2,000***
To close Income Summary account		

Account	Debit	Credit
Capital	***100***	
Drawing		***100***
To close Drawing account		

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Supplement - Practice Problem

This exercise requires that you complete two accounting periods, recording the transactions of Spaceley's Sprocket Market. Try to write out the entries and the income statements without looking at the solution, which is given to you at the bottom of the exercise.

Record the following transactions and the closing entries for the months of April and May. Prepare a multiple-step income statement for each month.

Date	Transaction
4/1:	Began operations by purchasing inventory items from Sprocket Supply House, $5,000, terms 1/10, n30 f.o.b. shipping point.
4/2:	Paid $200 of freight charges for the April 1 purchase.
4/3:	Returned merchandise which cost $2,000 to Sprocket Supply House.
4/15:	Paid Sprocket Supply House for the items purchased, less the return, not taking the cash discount.
4/16:	Sold sprockets to Astro Abercrombie for $2,000, terms 2/10, n30 f.o.b. destination. Determined that the goods had cost $1,000.
4/16:	Paid shipping charges of $50 from the April 16 sale.
4/20:	Astro Abercrombie complained that the sprockets were not the correct shape and returned $800 ($400 cost) worth of them.
4/30:	Astro Abercrombie paid his account, less the return, not taking the cash discount.
4/30:	Took a physical count of the ending inventory and carefully traced costs to the goods still on hand. Prepared a multiple-step income statement for April. Other selling expenses (in addition to Delivery Expense) were comprised of sales salaries expense of $200, and other administrative expenses of $600.
5/2:	Purchased inventory items from Jupiter Sprocket Manufacturing Company, $10,000, terms 1/10, n30 f.o.b. shipping point.
5/2:	Paid $400 freight charges for the May 2 purchase.
5/3:	Complained about the quality of the merchandise but agreed to keep it when Jupiter offered to take $2,000 off the original purchase price.
5/11:	Paid Jupiter Sprocket Manufacturing Company for the items purchased, less the allowance, taking the cash discount.
5/12:	Sold more sprockets to Astro Abercrombie for $6,000, terms 2/10, n30 f.o.b. destination. Determined that the goods had cost $2,900.
5/13:	Paid shipping charges of $200 from the May 12 sale.
5/15:	Astro Abercrombie complained that the sprockets were of poor quality, but agreed to keep them when offered a $1,000 reduction in price.
5/21:	Astro Abercrombie paid his account, less the allowance, taking the cash discount.
5/31	Took a physical count of the ending inventory and carefully traced costs to the goods still on hand. Prepared a multiple-step income statement for May. Other selling expenses (in addition to Delivery Expense) were comprised of utilities expense of $1,000, and other administrative expenses totaled $2,000.

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Solution to Summary Practice Problem, Module 6

April Transactions:			
4/1	Inventory	5000	
	Accounts Payable		5000
4/2	Inventory	200	
	Cash		200
4/3	Accounts Payable	2000	
	Inventory		2000
4/15	Accounts Payable	3000	
	Cash		3000
4/16	Accounts Receivable	2000	
	Sales		2000
	Cost of Goods Sold	1000	
	Inventory		1000
4/16	Delivery Expense	50	
	Cash		50
4/20	Sales Returns and Allowances	800	
	Accounts Receivable		800
	Inventory	400	
	Cost of Goods Sold		400
4/30	Cash	1200	
	Accounts Receivable		1200

Spaceley Sprocket Discount Mart
Income Statement
for the Month Ended April 30

Revenues:			
Sales		$ 2,000	
Less: Sales Returns and Allowances		(800)	
Net Sales			$ 1,200
Cost of Goods Sold			(600)
Gross Profit			$ 600
Operating Expenses:			
Selling Expenses:			
Delivery Expense	$ 50		
Sales Salaries Expense	200		
Total Selling Expenses		$ 250	
General and Administrative Expenses			
Other Administrative Expenses		600	
Total Operating Expenses			(850)
Net Loss			$ (250)

Closing entries:

4/30	Sales	2,000	
	Income Summary		2,000
4/30	Income Summary	2,250	
	Sales Returns and Allowances		800
	Cost of Goods Sold		600
	Delivery Expense		50
	Sales Salaries Expense		200
	Other Administrative Expenses		600
4/30	Spaceley, Capital	250	
	Income Summary		250

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Date	Account		Debit	Credit
May Transactions:				
5/2	Inventory		10,000	
	Accounts Payable			10,000
5/2	Inventory		400	
	Cash			400
5/3	Accounts Payable		2,000	
	Inventory			2,000
5/11	Accounts Payable		8,000	
	Inventory			80
	Cash			7,920
5/12	Accounts Receivable		6,000	
	Sales			6,000
	Cost of Goods Sold		2,900	
	Inventory			2,900
5/13	Delivery Expense		200	
	Cash			200
5/15	Sales Returns and Allowances		1,000	
	Accounts Receivable			1,000
5/21	Cash		4,900	
	Sales Discounts		100	
	Accounts Receivable			5,000

Spaceley Sprocket Discount Mart
Income Statement
for the Month EndedMay 31

Revenues:				
Sales			$ 6,000	
Less:	Sales Returns and Allowances	(1,000)		
	Sales Discounts	(100)	(1,100)	
Net Sales				$ 4,900
Cost of Goods Sold				2,900
Gross Profit				$ 2,000
Operating Expenses:				
Selling Expenses:				
Delivery Expense		200		
Utilities Expense		1,000		
Total Selling Expenses			1,200	
General and Administrative Expenses				
Other Administrative Expenses			2,000	
Total Operating Expenses				(3,200)
Net Loss				$ (1,200)

Date	Account		Debit	Credit
Closing entries:				
5/31	Sales		6,000	
	Income Summary			6,000
5/31	Income Summary		7,200	
	Sales Returns and Allowances			1,000
	Sales Discounts			100
	Cost of Goods Sold			2,900
	Utilities Expense			1,000
	Delivery Expense			200
	Other Administrative Expenses			2,000
5/31	Spaceley, Capital		1,200	
	Income Summary			1,200

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