WILEY

weygandt
kimmel
kieso
team for success

FINANCIAL ACCOUNTING 3e

IFRS EDITION

Prepared by
Coby Harmon
University of California, Santa Barbara
Westmont College

PREVIEW OF CHAPTER 5

ACCOUNTING FOR MERCHANDISING OPERATIONS

Merchandising Operations	Recording Purchases of Merchandise	Recording Sales of Merchandise	Completing the Accounting Cycle	Forms of Financial Statements
• Operating cycles • Flow of costs—perpetual and periodic inventory systems	• Freight costs • Purchase returns and allowances • Purchase discounts • Summary of purchasing transactions	• Sales returns and allowances • Sales discounts	• Adjusting entries • Closing entries • Summary of merchandising entries	• Income statement • Inventory presentation in the classified statement of financial position

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.

Merchandising Operations

Merchandising Companies

Buy and Sell Goods

Learning Objective 1
Identify the differences between service and merchandising companies.

Retailer

Wholesaler

Consumer

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

Merchandising Operations

Income Measurement

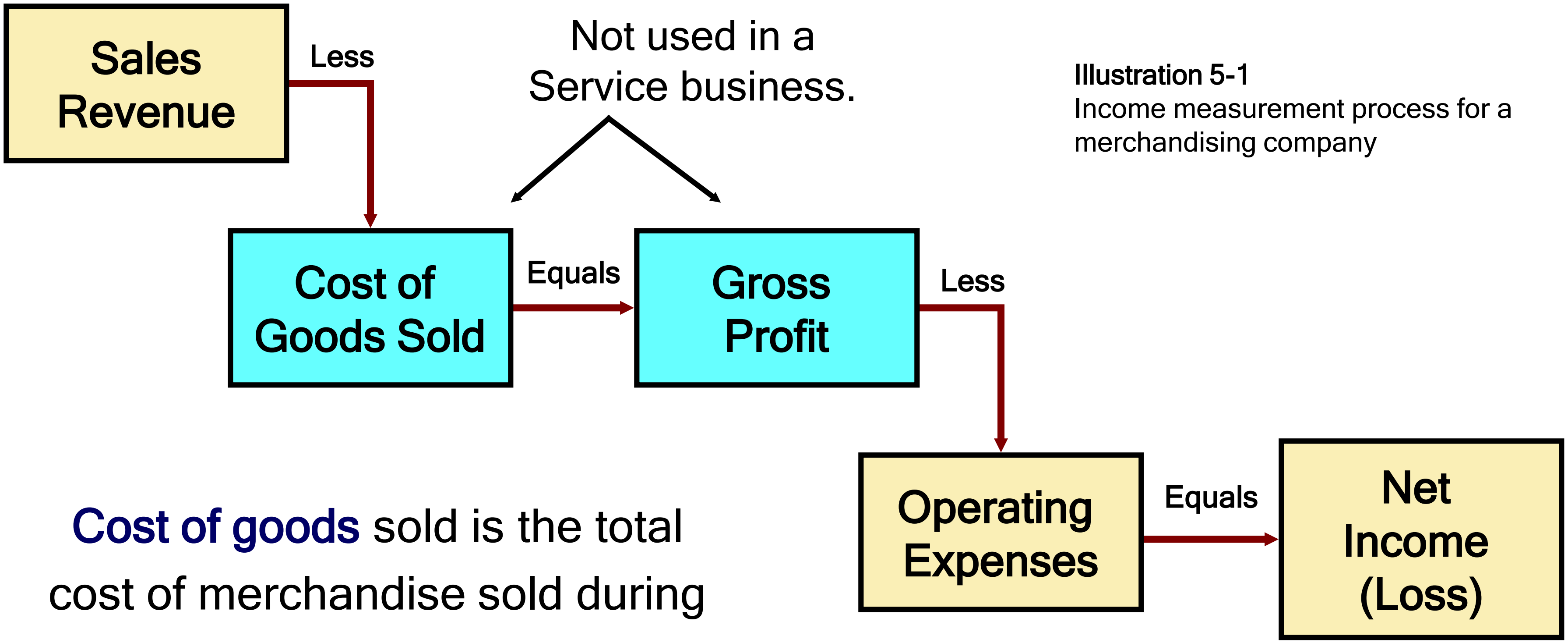


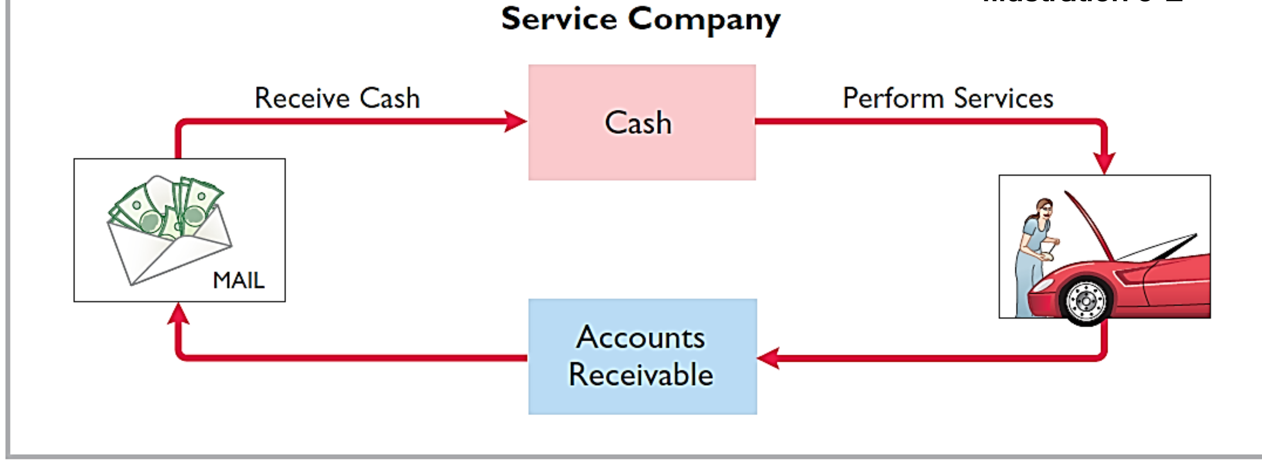
Illustration 5-1
Income measurement process for a merchandising company

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

Operating Cycles

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

Illustration 5-2



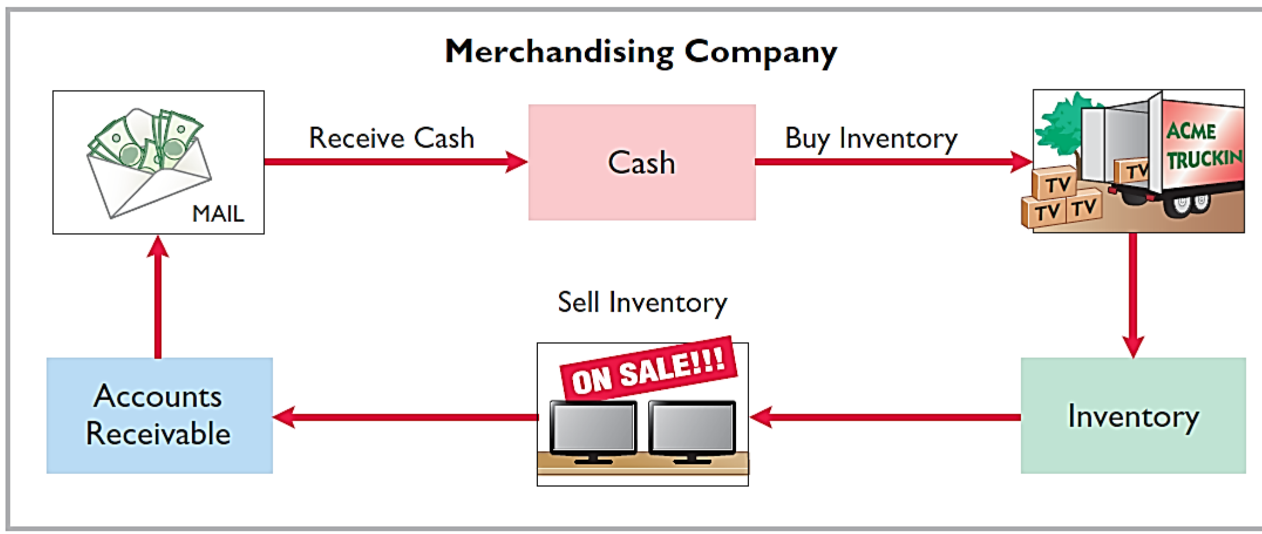
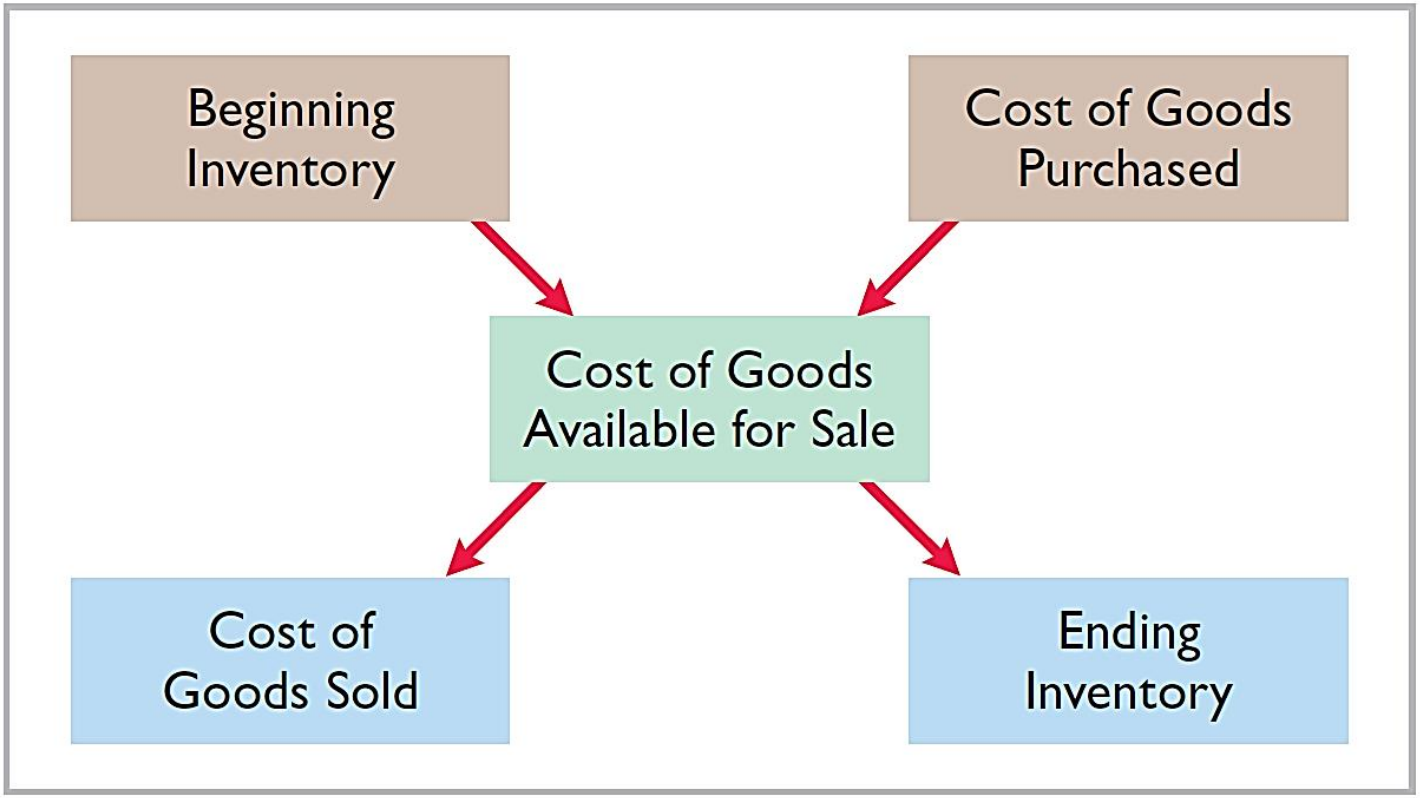


Illustration 5-3

Flow of Costs

Illustration 5-4



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

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 for every item.
- Company determines cost of goods sold each time a sale occurs.

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	900,000
Less: Ending inventory	125,000
Cost of goods sold	€ 775,000

Flow of Costs

ADVANTAGES OF THE PERPETUAL SYSTEM

- Traditionally used for merchandise with high unit values.
- Shows the quantity and cost of the inventory that should be on hand at any time.
- Provides better control over inventories than a periodic system.

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, the company stated that it would perform a physical inventory count every quarter until it felt that its perpetual inventory system was reliable.

> DO IT!

Indicate whether the following statements are **true** or **false**.

1. The primary source of revenue for a merchandising company results from performing services for customers. **False**

2. The operating cycle of a service company is usually shorter than that of a merchandising company. **True**

3. Sales revenue less cost of goods sold equals gross profit. **True**

4. Ending inventory plus the cost of goods purchased equals cost of goods available for sale. **False**

Recording Purchases of Merchandise

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

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

INVOICE NO. 731

PW AUDIO SUPPLY, SE
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 5/4/17 | 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

Illustration 5-6
Sales invoice used as purchase invoice by Sauk Stereo

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

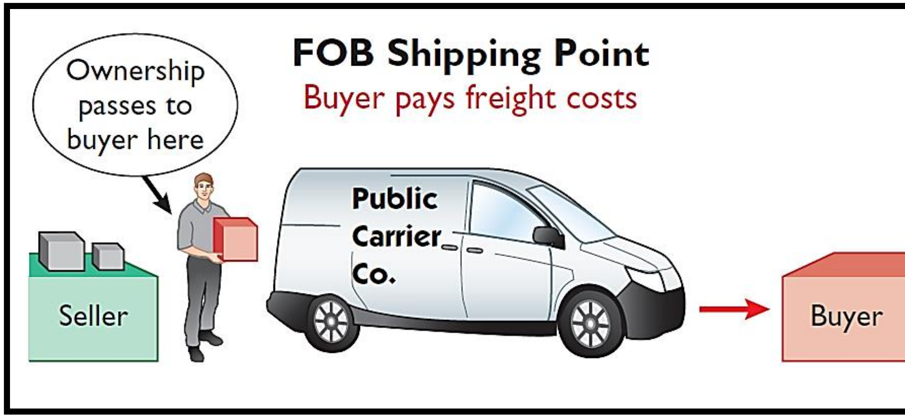
PW AUDIO SUPPLY, SE
27 CIRCLE DRIVE
AMSTERDAM, THE NETHERLANDS 1081

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

Date 5/4/17	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

May 4	Inventory	3,800	
	Accounts Payable		3,800

Freight Costs



Ownership of the goods passes to the buyer when the public carrier accepts the goods from the seller.

Ownership of the goods remains with the seller until the goods reach the buyer.

Illustration 5-7
Shipping terms

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

Freight Costs

Illustration: Assume upon delivery of the goods on May 6, **Sauk Stereo pays** Public Freight Company €150 for **freight charges**, the entry on Sauk Stereo's books is:

May 6	Inventory	150	
	Cash		150

Assume the freight terms on the invoice in Illustration 5-6 had required **PW Audio Supply to pay the freight charges**, the entry by PW Audio Supply would have been:

May 4	Freight-Out (Delivery Expense)	150	
	Cash		150

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 a reduction from the purchase price.

Purchase Returns and Allowances

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

May 8	Accounts Payable	300	
	Inventory		300

Purchase Returns and Allowances

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

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 by converting the accounts receivable into cash earlier.

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.

Purchase Discounts

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 on May 14 to record the payment.

May 14	Accounts Payable	3,500	
	Inventory		70
	Cash		3,430

(Discount = €3,500 x 2% = **€70**)

Purchase Discounts

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

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%

€3,500 x 36.5% x 20 ÷ 365 = €70

Summary of Purchasing Transactions

Inventory

	Debit	Credit	
4^{th} - Purchase	3,800	300	8^{th} - Return
6^{th} - Freight-in	150	70	14^{th} - Discount
Balance	3,580		

> DO IT!

On September 5, Zhu Company buys merchandise on account from Gao Company. The selling price of the goods is ¥15,000, and the cost to Gao Company was ¥8,000. On September 8, Zhu returns defective goods with a selling price of ¥2,000. Record the transactions on the books of Zhu Company.

Sept. 5	Inventory	15,000	
	Accounts Payable		15,000
Sept. 8	Accounts Payable	2,000	
	Inventory		2,000

Recording Sales of Merchandise

Learning Objective 3
Explain the recording of sales revenue under a perpetual inventory system.

- Made using **cash or credit** (on account).
- Sales revenue, like service revenue, is recorded when the performance obligation is satisfied.
- Performance obligation is satisfied when the goods are transferred from the seller to the buyer.
- Sales invoice should support each credit sale.

INVOICE NO. 731

PW AUDIO SUPPLY, SE
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 5/4/17	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

Illustration 5-6

Recording Sales of Merchandise

Journal Entries to Record a Sale

		Debit	Credit	
#1	Cash **or** Accounts Receivable	XXX		Selling Price
	Sales Revenue		XXX	
#2	Cost of Goods Sold	XXX		Cost
	Inventory		XXX	

Recording Sales of Merchandise

Illustration: PW Audio Supply records the sale of €3,800 on May 4 to Sauk Stereo on account (Illustration 5-6) as follows (assume the merchandise cost PW Audio Supply €2,400).

May 4	Accounts Receivable	3,800	
	Sales Revenue		3,800
4	Cost of Goods Sold	2,400	
	Inventory		2,400

ANATOMY OF A FRAUD

Holly Harmon was a cashier at a national superstore for only a short while when she began stealing merchandise using three methods. Under the first method, 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. Using the second method, Holly scanned an item at the register 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 scanned 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

ANATOMY OF A FRAUD

Holly Harmon was a cashier at a national superstore for only a short while when she began stealing merchandise using three methods. Under the first method, 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. Using the second method, Holly scanned an item at the register 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 scanned 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

Physical controls. Software can flag high numbers of voided transactions or a high number of sales of low-priced goods. Random comparisons of video records with cash register records can ensure that the goods reported as sold on the register are the same goods that are shown being purchased on the video recording. Employees should be aware that they are being monitored.

Sales Returns and Allowances

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

Sales Returns and Allowances

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
8	Inventory	140	
	Cost of Goods Sold		140

Sales Returns and Allowances

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
8	Inventory	50	
	Cost of Goods Sold		50

Sales Returns and Allowances

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.

ACCOUNTING ACROSS THE ORGANIZATION

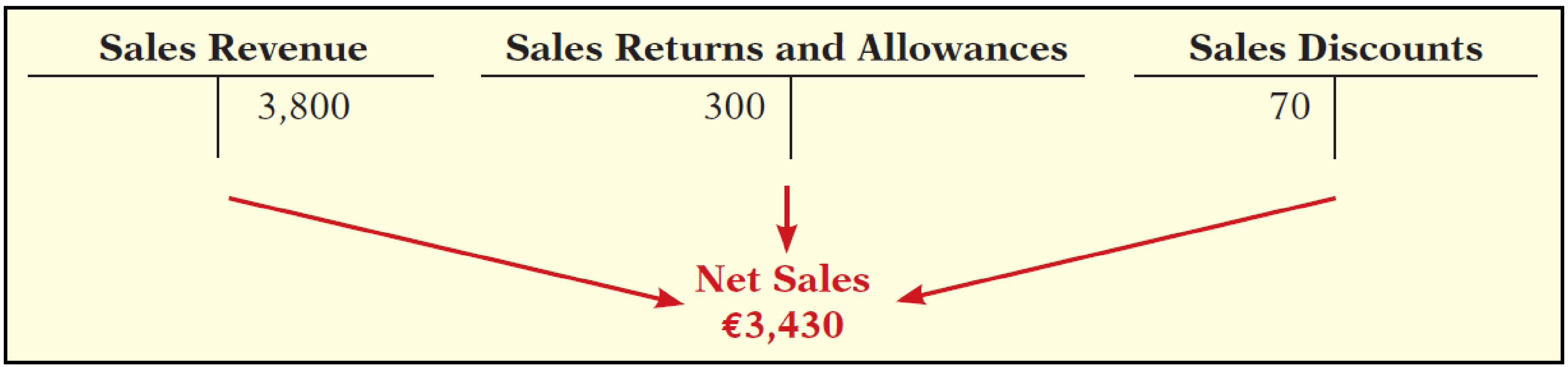
Merchandiser's Accounting Causes Alarm

Accounting for merchandising transactions is not always as easy as it might first appear. Recently, Tesco (GBR) announced that it had overstated profits by £263 million over a three-year period. The error related to how Tesco accounted for amounts received from suppliers for promotional activities of those companies' products. When a retailer runs advertisements promoting a particular product, the producer of that product shares part of the advertising cost. Typically, the producer pays the merchandiser its share of the advertising cost as much as a year before the advertisement is run. The questions become, how should these amounts be reported by the merchandiser at the time it receives the funds, and when should these amounts affect income? The scandal surrounding this accounting treatment was serious enough that it caused the company's chairman to resign, and an outside auditing firm was brought in to investigate. One analyst commentated that "we can never recall a period so damaging to the reputation of the company."

Source: Jenny Anderson, "Tesco Chairman to Step Down as Overstatement of Profit Grows," *The New York Times Online* (October 23, 2014).

Sales Discount

- Offered to customers to **promote prompt payment** of the balance due.
- **Contra-revenue account** (debit) to Sales Revenue.



Sales Discount

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%]

> DO IT!

On September 5, Zhu Company buys merchandise on account from Gao Company. The selling price of the goods is ¥15,000, and the cost to Gao Company was ¥8,000. On September 8, Zhu returns defective goods with a selling price of ¥2,000 and the fair value of ¥300. Record the transactions on the books of Gao Company.

Sept. 5	Accounts Receivable	15,000	
	Sales Revenue		15,000
Sept. 5	Cost of Goods Sold	8,000	
	Inventory		8,000

> DO IT!

On September 5, Zhu Company buys merchandise on account from Gao Company. The selling price of the goods is ¥15,000, and the cost to Gao Company was ¥8,000. On September 8, Zhu returns defective goods with a selling price of ¥2,000 and the fair value of ¥300. Record the transactions on the books of Gao Company.

Sept. 8	Sales Returns and Allowances	2,000	
	Accounts Receivable		2,000
Sept. 8	Inventory	300	
	Cost of Goods Sold		300

Recording Sales of Merchandise

Learning Objective 4
Explain the steps in the accounting cycle for a merchandising company.

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.

Adjusting Entries

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

Cost of Goods Sold	500	
Inventory		500

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)		

Closing Entries

Dec. 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)		

> 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.

Dec. 31	Sales Revenue	162,400	
	Rent Revenue	6,000	
	Income Summary		168,400

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.

Dec. 31	Income Summary	151,000	
	Cost of Goods Sold		110,000
	Sales Returns and Allowances		4,800
	Sales Discounts		3,600
	Freight-Out		1,800
	Rent Expense		8,800
	Salaries and Wages Expense		22,000

Forms of Financial Statements

Learning Objective 5
Prepare an income statement for a merchandiser.

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.

Income Statement

The income statement is a primary source of information for evaluating a company's performance.

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
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

LO 5

Income Statement

Key Items:

- Net sales

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
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

LO 5

Income Statement

Key Items:

- Net sales
- Gross profit

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
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

LO 5

Income Statement

Key Items:

- Net sales
- Gross profit

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
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	
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

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

Illustration 5-11
Gross profit rate formula and computation

LO 5

Income Statement

Key Items:

- Net sales
- Gross profit
- Operating expenses

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
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

LO 5

Income Statement

Key Items:

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

PW AUDIO SUPPLY, SE
Income Statement
For the Year Ended December 31, 2017

Sales		
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

Income Statement

Key Items:

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

PW AUDIO SUPPLY, SE
Income Statement
For the Year Ended December 31, 2017

Sales		
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

Income Statement

Key Items:

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

PW AUDIO SUPPLY, SE Income Statement For the Year Ended December 31, 2017		
Sales		
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

Income Statement

Key Items:

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

PW AUDIO SUPPLY, SE
Income Statement
For the Year Ended December 31, 2017

Sales		
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

LO 5

Income Statement

Question

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

a. gross profit.

b. cost of goods sold.

c. a sales section.

d. investing activities section.

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.

PW AUDIO SUPPLY, SE Comprehensive Income Statement For the Year Ended December 31, 2017	
Net income	€31,600
Other comprehensive income	
Unrealized holding gain on investment securities	2,300
Comprehensive income	€33,900

Illustration 5-15
Separate statement of net income and comprehensive income

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

ACCOUNTING ACROSS THE ORGANIZATION

Online Sales Stall in India

India is well known for its large pool of excellent software engineers. Therefore, it may come as a surprise that online merchandise sales are only starting to take hold in this country. The reason for the delay compared to many other countries is that, until recently, consistent Internet access was limited to a small portion of the Indian population. But, experts predict that by 2015 up to 200 million Indians will have Internet access. To take advantage of this, two software engineers started the online merchandising company **Flipkart** (IND). Their goal is "to be the Amazon. com of India." Sales hit $20 million in a recent year, but the company faces many barriers to both growth and profitability. First, few Indians have credit cards, so many transactions must be done in cash. And, while the company has a book catalog of over 100 million titles, it is very difficult to deliver those books (or anything else) over India's poorly maintained roads. As a consequence, even if Internet access improves rapidly, online merchandisers need to see improvements in the banking and transportation systems in India for sales to really take off.

Source: Amol Sharma, "Dot-Coms Begin to Blossom in India," *Wall Street Journal* (April 12, 2011).

Inventory Presentation in the Classified Statement of Financial Position

PW AUDIO SUPPLY, SE
Statement of Financial Position (Partial)
December 31, 2017

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

Illustration 5-16
Assets section of a classified statement of financial position

> 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 (due in 3 years)	SFP	Non-current liabilities

> 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	Current liabilities
Salaries and Wages Expense	IS	Operating expenses
Salaries and Wages Payable	SFP	Current liabilities
Sales Returns and Allowances	IS	Sales
Sales Revenue	IS	Sales
Share Capital—Ordinary	SFP	Equity
Utilities Expense	IS	Operating expenses

APPENDIX 5A

Worksheet for a Merchandising Company

Learning Objective 6
Prepare a worksheet for a merchandising company.

Using a Worksheet

As indicated in Chapter 4, a worksheet enables companies to prepare financial statements before they journalize and post adjusting entries. The steps in preparing a worksheet for a merchandising company are the same as for a service company. Illustration 5A-1 shows the worksheet for PW Audio Supply (excluding nonoperating items). The unique accounts for a merchandiser using a **perpetual inventory system** are in **red**.

Illustration 5A-1
Worksheet for merchandising company

PW AUDIO SUPPLY, SE
Worksheet
For the Year Ended December 31, 2017

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

Learning Objective 7
Explain the recording of purchases and sales of inventory under a periodic inventory system.

Determining Cost of Goods Sold Under a Periodic System

- No running account of changes in inventory.
- Ending inventory determined by physical count.
- Cost of goods sold not determined until the end of the period.

Determining Cost of Goods Sold Under a Periodic System

Illustration 5B-2
Cost of goods sold for a merchandiser using a periodic inventory system

PW AUDIO SUPPLY, SE Cost of Goods Sold For the Year Ended December 31, 2017			
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

Recording Merchandise Transactions

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

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

Recording Purchases of Merchandise

FREIGHT COSTS

Illustration: If Sauk pays Public 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

Recording Purchases of Merchandise

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

Recording Purchases of Merchandise

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

Recording Sales of Merchandise

Illustration: PW Audio Supply, records the sale of €3,800 of merchandise to Sauk Stereo on May 4 (sales invoice No. 731, Illustration 5-6) 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.

Recording Sales of Merchandise

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 8	Sales Returns and Allowances	300	
	Accounts Receivable		300

Recording Sales of Merchandise

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

Recording Sales of Merchandise

COMPARISON OF ENTRIES

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

Illustration 5B-3
Comparison of entries for perpetual and periodic inventory systems

Recording Sales of Merchandise

COMPARISON OF ENTRIES

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

Illustration 5B-3
Comparison of entries for perpetual and periodic inventory systems

Illustration 5B-5
Worksheet for merchandising company—periodic inventory system

PW AUDIO SUPPLY, SE
Worksheet
For the Year Ended December 31, 2017

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	36,000				36,000		36,000	40,000	40,000	
Prepaid Insurance	3,800			(a) 2,000	1,800				1,800	
Equipment	80,000				80,000				80,000	
Accumulated Depreciation—Equipment		16,000		(b) 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			
PURCHASES	325,000				325,000		325,000			
PURCHASE RETURNS AND ALLOWANCES		10,400				10,400		10,400		
PURCHASE DISCOUNTS		6,800				6,800		6,800		
FREIGHT-IN	12,200				12,200		12,200			
Freight-Out	7,000				7,000		7,000			
Advertising Expense	16,000				16,000		16,000			
Salaries and Wages Expense	59,000		(c) 5,000		64,000		64,000			
Utilities Expense	17,000				17,000		17,000			
Totals	616,600	616,600								
Insurance Expense			(a) 2,000		2,000		2,000			
Depreciation Expense			(b) 8,000		8,000		8,000			
Salaries and Wages Payable				(c) 5,000		5,000				5,000
Totals			15,000	15,000	629,600	629,600	507,200	537,200	162,400	132,400
Net Income							30,000			30,000
Totals							537,200	537,200	162,400	162,400

LO 7

A Look at U.S. GAAP

Learning Objective 8
Compare the accounting for merchandising under IFRS and U.S. GAAP.

Key Points

Similarities

- 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 performing of services. The definition under GAAP is essentially the same.
- Similar to GAAP, comprehensive income under IFRS includes unrealized gains and losses (such as those on non-trading securities) that are not included in the calculation of net income.

A Look at U.S. GAAP

Key Points

Differences

- 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.

A Look at U.S. GAAP

Key Points

Differences

- 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.
- IFRS requires that two years of income statement information be presented, whereas GAAP requires three years.

A Look at U.S. GAAP

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 analysts.

A Look at U.S. GAAP

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.

A Look at U.S. GAAP

IFRS Self-Test Questions

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

a) Depreciation expense.

b) Interest expense.

c) Salaries and wages expense.

d) Manufacturing expense.

A Look at U.S. GAAP

IFRS Self-Test Questions

Which of the following statements is **false**?

a) GAAP specifically requires use of a multiple-step income statement.

b) Under GAAP, companies can use either a perpetual or periodic system.

c) The proposed new format for financial statements was heavily influenced by the suggestions of financial statement analysts.

d) The new income statement format will try to de-emphasize the focus on the “net income” line item.

Copyright