PRINCIPLES OF ACCOUNTING

CHAPTER 6

Accounting for Merchandising Businesses

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Chapter Introduction

A merchandising business purchases products and resells them to customers. Its accounting system must record:

Merchandise Flow

- Merchandise purchased
- Merchandise available for sale
- Merchandise sold
- Inventory shortages

Revenue and Cost Elements

- Sales revenue
- Cost of merchandise sold
- Customer returns and supplier returns
- Purchase and sales discounts
- Freight costs

Opening Case — Dollar Tree Stores

Dollar Tree operates thousands of retail stores and sells a large variety of merchandise. Its accounting system must determine:

Inventory Questions

- What merchandise is available
- Where merchandise is located
- How much merchandise was sold
- Inventory losses

Cost Questions

- The cost of items sold
- Delivery costs
- Discounts
- Returns

Key message: accounting for a merchandising business is more complex than accounting for a service business.

Why This Chapter Matters

Merchandise inventory is often one of a retailer's largest assets, and cost of merchandise sold is often its largest expense.

Errors in merchandising transactions may therefore materially affect:

Statement Effects

- Inventory
- Revenue
- Gross profit
- Net income

Wider Effects

- Current assets
- Owner's equity
- Tax and management decisions

Learning Objectives

By the end of this chapter, students will be able to:

1. **Distinguish service and merchandising businesses.**
2. **Describe the operating cycle of a merchandising business.**
3. **Prepare merchandising financial statements.**
4. **Calculate net sales and gross profit.**
5. **Calculate cost of merchandise sold.**
6. **Record merchandise sales.**
7. **Record merchandise purchases.**
8. **Account for returns, allowances and discounts.**
9. **Account for freight and sales taxes.**
10. **Explain trade discounts.**
11. **Compare entries made by buyers and sellers.**
12. **Record inventory shrinkage.**
13. **Prepare closing entries for a merchandising business.**

Chapter Roadmap

Foundations and Reporting

- Nature of merchandising businesses
- Operating cycle
- Merchandising financial statements
- Perpetual and periodic inventory systems
- Sales transactions
- Purchase transactions
- Returns and allowances
- Cash discounts

Special Topics and Close

- Freight terms
- Sales taxes and trade discounts
- Buyer and seller accounting
- Inventory shrinkage
- Closing entries
- Financial analysis
- Comprehensive exercise

Opening Reflection

A retailer purchases an item for ETB 800 and sells it for ETB 1,200. During the same period it incurs delivery cost ETB 40, advertising expense ETB 100 and employee salary ETB 150.

QUESTIONS FOR DISCUSSION

- **What is sales revenue?**
- **What is cost of merchandise sold?**
- **What is gross profit?**
- **Is gross profit the same as net income?**

Section 1

Nature of Merchandising Businesses

Service versus Merchandising Businesses

Service Business — provides services

- Consulting firm
- Bank
- Hotel
- Transport company

Merchandising Business — buys and resells

- Supermarket
- Pharmacy
- Clothing store
- Electronics retailer

Service-Business Income Statement

A service business normally reports:

Item	Amount
Fees earned	XXX
Less: Operating expenses	(XXX)
Net income	**XXX**

> *There is normally no merchandise inventory or cost of merchandise sold.*

Merchandising-Business Income Statement

A merchandising business normally reports:

Item	Amount
Net sales	XXX
Less: Cost of merchandise sold	(XXX)
Gross profit	XXX
Less: Operating expenses	(XXX)
Net income	**XXX**

Gross Profit

Gross profit is the excess of net sales over the cost of merchandise sold.

Formula

Net Sales − Cost of Merchandise Sold

= Gross Profit

Gross profit is calculated before deducting operating expenses.

Gross-Profit Example

Cash sales
ETB 250,000

Credit sales
ETB 975,000

Cost of merchandise sold
ETB 735,000

Total sales
250,000 + 975,000
ETB 1,225,000

Gross profit
1,225,000 − 735,000
ETB 490,000

Merchandise Inventory

Merchandise inventory consists of goods:

- **Purchased for resale**
- **Owned by the business**
- **Available for sale**
- **Not yet sold to customers**

Financial-statement classification

Current Asset

Operating Cycle of a Merchandising Business

The operating cycle generally follows this sequence:

- **Cash**
- Purchase merchandise
- Merchandise inventory
- Sell merchandise
- Accounts receivable or cash
- **Collect cash**

Length of the Operating Cycle

The operating cycle depends on:

Business Factors

- Type of merchandise
- Customer credit terms
- Inventory turnover

Market Factors

- Collection speed
- Market demand
- Supply-chain conditions

Grocery stores normally have short cycles; jewellery and automobile businesses may have longer cycles.

Knowledge Check — Classification

Item	Classification
Merchandise held for resale	Current asset
Cost of products sold	Expense
Amount charged to customers	Sales revenue
Sales less cost of merchandise sold	Gross profit
Advertising cost	Operating expense

Section 2

Merchandising Financial Statements

Merchandising Financial Statements

Principal Statements

- Income statement
- Statement of owner's equity
- Balance sheet
- Statement of cash flows

Main Differences from a Service Business

- Inventory reporting
- Sales reporting
- Cost of merchandise sold
- Gross profit

Multiple-Step Income Statement

A multiple-step income statement contains several sections, subsections and subtotals. Major sections include:

1. **Revenue from sales**
2. **Cost of merchandise sold**
3. **Gross profit**
4. **Operating expenses**
5. **Income from operations**
6. **Other income and expense**
7. **Net income**

Revenue from Sales Section

The revenue section normally includes:

- **Sales**
- **Sales returns and allowances**
- **Sales discounts**
- **Net sales**

> *Sales represents the total amount charged to customers for merchandise sold.*

Net Sales Formula

Net Sales

Sales − Sales Returns and Allowances − Sales Discounts

= Net Sales

Sales returns and allowances and sales discounts are contra-revenue accounts with normal debit balances.

Net Sales Example

Item	Amount
Sales	ETB 720,185
Less: Sales returns and allowances	(6,140)
Less: Sales discounts	(5,790)
Net sales	**ETB 708,255**

Cost of Merchandise Sold

Cost of merchandise sold is the cost of the merchandise sold to customers during the reporting period.

It is matched against sales revenue to determine gross profit.

> *It does not necessarily equal merchandise purchased during the period.*

Cost of Merchandise Sold Formula

UNDER A PERIODIC INVENTORY APPROACH

Beginning inventory
XXX

Plus cost of merchandise purchased
+ XXX

Less ending inventory
− XXX

Result
Beginning Inventory + Cost of Merchandise Purchased − Ending Inventory
= Cost of Merchandise Sold

Cost of Merchandise Purchased

Net purchases

Purchases − Purchases Returns and Allowances − Purchases Discounts

= Net Purchases

Cost of merchandise purchased

Net Purchases + Freight In

= Cost of Merchandise Purchased

Cost of Merchandise Purchased — Example

Item	Amount
Purchases	ETB 521,980
Less: Purchase returns and allowances	(9,100)
Less: Purchase discounts	(2,525)
Net purchases	510,355
Add: Freight in	17,400
Cost of merchandise purchased	ETB 527,755

Cost of Merchandise Sold — Example

Item	Amount
Beginning inventory	ETB 59,700
Cost of merchandise purchased	527,755
Merchandise available for sale	587,455
Less: Ending inventory	(62,150)
Cost of merchandise sold	ETB 525,305

Perpetual Inventory System

Under the perpetual inventory system:

- **Purchases increase Merchandise Inventory.**
- **Sales reduce Merchandise Inventory.**
- **Cost of Merchandise Sold is recorded at every sale.**
- **Inventory records are continuously updated.**
- **The inventory balance should represent goods currently on hand.**

Periodic versus Perpetual Systems

Perpetual System	Periodic System
Continuously updates inventory	Updates inventory at period-end
Records cost at each sale	Calculates cost after physical count
Uses Merchandise Inventory for purchases	Uses Purchases and related accounts
Provides continuous inventory information	Provides limited interim information
Common in computerized systems	Common in smaller manual systems

Gross Profit Section

Using the previous figures:

Item	Amount
Net sales	ETB 708,255
Cost of merchandise sold	(525,305)
Gross profit	**ETB 182,950**

Operating Expenses

Operating expenses are costs incurred in the normal operation of the merchandising business. They are commonly classified into two groups:

Group 1
Selling Expenses

Group 2
Administrative Expenses

Selling Expenses

Selling expenses are directly related to marketing, selling and delivering merchandise.

Examples

- Sales salaries
- Advertising
- Store depreciation
- Store supplies

Examples

- Delivery expense
- Sales commissions
- Promotional costs

Administrative Expenses

Administrative expenses relate to general management and office operations.

Examples

- Office salaries
- Office rent
- Office equipment depreciation

Examples

- Insurance expense
- Office supplies
- Professional fees

Income from Operations

Formula

Gross Profit – Operating Expenses

= Income from Operations

Example

182,950 – 105,710

ETB 77,240

Other Income and Expense

Other income and expenses are not directly related to the principal merchandising activities.

Other Income

- Interest revenue
- Rent revenue
- Gains on asset disposal

Other Expenses

- Interest expense
- Losses on asset disposal

Multiple-Step Income Statement — Example

Item	Amount
Net sales	ETB 708,255
Cost of merchandise sold	(525,305)
Gross profit	182,950
Selling expenses	(70,820)
Administrative expenses	(34,890)
Income from operations	77,240
Net other expense	(1,840)
Net income	**ETB 75,400**

Single-Step Income Statement

The single-step format groups all revenues together and all expenses together.

Formula

Total Revenues − Total Expenses

= Net Income

Multiple-Step versus Single-Step

Multiple-Step	Single-Step
Reports gross profit	Does not report gross profit
Reports income from operations	Does not separately report operating income
Separates operating and non-operating items	Combines revenues and expenses
Provides more analytical detail	Simpler presentation

Statement of Owner's Equity

The statement is prepared in the same manner as for a service business.

Beginning capital
XXX

Add additional investment
+ XXX

Add net income
+ XXX

Less withdrawals
– XXX

The result is ending capital, which is also reported on the balance sheet.

Balance-Sheet Presentation

Merchandise Inventory is reported as a current asset. The balance sheet may be presented using either of two forms:

Account Form

- Assets on the left
- Liabilities and equity on the right

Report Form

- Assets, liabilities and equity presented vertically

Financial-Statement Knowledge Check

Which statement or section reports each item?

Item	Location
Sales discounts	Income Statement
Gross profit	Income Statement
Merchandise inventory	Balance Sheet
Cost of merchandise sold	Income Statement
Ending capital	Owner's Equity and Balance Sheet
Accounts payable	Balance Sheet

Section 3

Merchandising Accounts

Chart of Accounts

A merchandising chart of accounts includes additional accounts such as:

Asset and Revenue Accounts

- Merchandise Inventory
- Sales
- Sales Returns and Allowances
- Sales Discounts

Cost, Expense and Liability Accounts

- Cost of Merchandise Sold
- Delivery Expense
- Sales Tax Payable

Contra-Revenue Accounts

Two accounts reduce Sales:

Sales Returns and Allowances

- Records merchandise returned by customers
- Records selling-price reductions

Sales Discounts

- Records discounts granted for early payment

Both accounts normally have debit balances.

Section 4

Sales Transactions

Dual Entry for a Sale

Under the perpetual inventory system, a sale normally requires two entries.

Entry 1 — Revenue

- Records sales revenue
- Records the amount received or receivable

Entry 2 — Cost

- Records cost of merchandise sold
- Records the reduction of inventory

Cash Sale Example

Merchandise is sold for ETB 18,000 cash. The merchandise cost ETB 12,000.

RECORD THE SALE

Account	Debit	Credit
Cash	18,000	
Sales		18,000

RECORD THE COST

Account	Debit	Credit
Cost of Merchandise Sold	12,000	
Merchandise Inventory		12,000

Credit-Card Sales

Most credit-card transactions processed through clearing systems are treated as cash sales.

Record the Sale

- Debit Cash
- Credit Sales

Processing Fees

- Credit-card processing fees are normally recorded separately as an expense

Credit-Card Fee Example

Monthly credit-card processing charges are ETB 4,800.

Account	Debit	Credit
Credit Card Expense	4,800	
Cash		4,800

Sale on Account

Merchandise is sold on account for ETB 51,000. The cost is ETB 28,000.

SALE ENTRY

Account	Debit	Credit
Accounts Receivable	51,000	
Sales		51,000

COST ENTRY

Account	Debit	Credit
Cost of Merchandise Sold	28,000	
Merchandise Inventory		28,000

Credit Terms

Credit terms specify when customers must pay.

Terms	Meaning
n/30	The full amount is due within 30 days
n/eom	The full amount is due at the end of the month
2/10, n/30	2% discount if paid within 10 days; otherwise full amount due within 30 days

Interpreting 2/10, n/30

Invoice amount

ETB 50,000

Discount

50,000 × 2%

ETB 1,000

Paid in discount period

50,000 – 1,000

ETB 49,000

Recording a Sales Discount

A customer pays a debt of ETB 50,000 within the 2% discount period.

Account	Debit	Credit
Cash	49,000	
Sales Discounts	1,000	
Accounts Receivable		50,000

Sales Returns and Allowances

Sales Return

- The customer returns merchandise to the seller

Sales Allowance

- The customer keeps the merchandise but receives a reduction in the selling price

POSSIBLE REASONS

- **Damage**
- **Defects**
- **Incorrect specifications**
- **Delivery problems**
- **Quality concerns**

Credit Memorandum

A credit memorandum, or credit memo:

- **Informs the customer of a reduction in the amount owed**
- **Decreases Accounts Receivable**
- **Provides evidence of a return or allowance**
- **Supports the accounting entry**

Sales Return Example

A customer returns merchandise originally sold for ETB 10,000. The merchandise cost ETB 6,000.

REVERSE PART OF THE SALE

Account	Debit	Credit
Sales Returns and Allowances	10,000	
Accounts Receivable		10,000

RESTORE THE INVENTORY

Account	Debit	Credit
Merchandise Inventory	6,000	
Cost of Merchandise Sold		6,000

Sales Allowance Example

A customer keeps damaged merchandise but receives an allowance of ETB 2,000.

Account	Debit	Credit
Sales Returns and Allowances	2,000	
Accounts Receivable		2,000

> *Normally, no inventory entry is made because the merchandise was not returned.*

Sales Knowledge Check

A customer owes ETB 40,000 under terms 2/10, n/30. The customer returns merchandise worth ETB 5,000 and pays within the discount period.

Amount subject to discount
40,000 – 5,000
ETB 35,000

Discount
35,000 × 2%
ETB 700

Cash received
35,000 – 700
ETB 34,300

Section 5

Purchase Transactions

Purchases under a Perpetual System

Under the perpetual inventory system, purchases of merchandise for resale are debited to:

Account debited

Merchandise Inventory

Separate Purchases and Freight In accounts are not normally used.

Purchase on Account

Merchandise costing ETB 50,000 is purchased on account.

Account	Debit	Credit
Merchandise Inventory	50,000	
Accounts Payable		50,000

Purchase Returns and Allowances

A buyer may:

- **Return merchandise to a supplier**
- **Retain merchandise and receive a price reduction**

> *Under the perpetual system, the buyer normally credits Merchandise Inventory.*

Purchase Return Example

Merchandise costing ETB 8,000 is returned to the supplier.

Account	Debit	Credit
Accounts Payable	8,000	
Merchandise Inventory		8,000

Purchase Discounts

A purchase discount is available when a buyer pays within the discount period.

Under the perpetual system, the discount reduces the cost of inventory.

> *Therefore, the buyer credits Merchandise Inventory.*

Purchase Sequence Example

1. Purchases merchandise for ETB 50,000, terms 2/10, n/30.
2. Returns merchandise costing ETB 10,000.
3. Pays within the discount period.

Amount subject to discount
50,000 – 10,000
ETB 40,000

Discount
40,000 × 2%
ETB 800

Cash paid
40,000 – 800
ETB 39,200

Purchase Settlement Entry

Account	Debit	Credit
Accounts Payable	40,000	
Cash		39,200
Merchandise Inventory		800

> *The discount of ETB 800 reduces the recorded cost of inventory rather than being reported as revenue.*

Seller versus Buyer Discount

Seller	Buyer
Records Sales Discounts	Reduces Merchandise Inventory
Sales Discounts has a debit balance	Merchandise Inventory is credited
Reduces net sales	Reduces inventory cost

Purchase Knowledge Check

Merchandise is purchased for ETB 80,000, terms 1/10, n/30. ETB 20,000 is returned. Payment is made within the discount period.

Amount due before discount
80,000 − 20,000
ETB 60,000

Discount
60,000 × 1%
ETB 600

Cash paid
60,000 − 600
ETB 59,400

Section 6

Freight, Sales Taxes and Trade Discounts

Freight Terms

Freight terms determine:

- **When ownership passes**
- **Who pays freight costs**
- **Whether freight is part of inventory cost**
- **Whether freight is a selling expense**

Term 1

FOB Shipping Point

Term 2

FOB Destination

FOB Shipping Point

- Ownership passes when goods are delivered to the carrier.
- The buyer normally pays freight.
- Freight paid by the buyer increases inventory cost.

BUYER'S ENTRY

Account	Debit	Credit
Merchandise Inventory	XXX	
Cash		XXX

FOB Destination

- Ownership passes when goods reach the buyer.
- The seller normally pays freight.
- Freight paid by the seller is a selling expense.

SELLER'S ENTRY

Account	Debit	Credit
Delivery Expense	XXX	
Cash		XXX

Seller Prepays Buyer's Freight

A seller may prepay freight even when terms are FOB shipping point. The seller then adds the freight to the customer's invoice.

Seller

- Debits Accounts Receivable
- Credits Cash

Buyer

- Debits Merchandise Inventory
- Credits Accounts Payable

> *The prepaid freight is generally not subject to the cash discount.*

Freight Summary

Shipping Terms	Ownership Passes	Freight Paid By	Buyer's Treatment
FOB shipping point	At seller's location / carrier	Buyer	Add to inventory
FOB destination	At buyer's location	Seller	No entry

Sales Taxes

The seller may collect sales tax from customers on behalf of a taxing authority.

The sales tax collected:

- **Is not sales revenue**
- **Creates a liability**
- **Must be remitted to the government**

Sales-Tax Entry

Merchandise is sold for ETB 100,000 plus 15% tax.

Tax
100,000 × 15%
ETB 15,000

Total receivable
100,000 + 15,000
ETB 115,000

Account	Debit	Credit
Accounts Receivable	115,000	
Sales		100,000
Sales Tax Payable		15,000

Remitting Sales Tax

When the tax is paid to the relevant authority:

Account	Debit	Credit
Sales Tax Payable	15,000	
Cash		15,000

> *The payment reduces the liability.*

Trade Discounts

Trade discounts are reductions from catalogue or list prices. They may be offered to:

Customer Types

- Wholesalers
- Government organizations
- Large-volume customers

Customer Types

- Preferred distributors
- Particular customer classes

Trade-Discount Example

List price
ETB 100,000

Trade discount
100,000 × 40%
ETB 40,000

Invoice price
100,000 − 40,000
ETB 60,000

The buyer and seller normally record ETB 60,000. The trade discount is not separately journalized.

Trade Discount versus Cash Discount

Trade Discount	Cash Discount
Reduces list price	Encourages early payment
Applied before recording	Recorded when payment occurs
Not separately journalized	Recorded in the accounts
Determines invoice price	Reduces amount collected or paid

Freight and Discount Knowledge Check

A buyer purchases merchandise for ETB 40,000, terms FOB shipping point, 2/10, n/30. Freight of ETB 3,000 is prepaid by the seller and added to the invoice.

Discount

40,000 × 2%

ETB 800

Cash payment

40,000 − 800 + 3,000

ETB 42,200

> *The freight is not included in the discount calculation.*

Section 7

Dual Nature of Merchandising Transactions

Buyer and Seller Perspectives

Every merchandising transaction involves two parties:

Seller

- Records sales revenue
- Records receivable or cash
- Records cost of merchandise sold
- Reduces inventory

Buyer

- Records inventory
- Records cash paid or liability owed

Sale on Account — Seller

Merchandise is sold for ETB 75,000 on account. Cost is ETB 45,000.

Account	Debit	Credit
Accounts Receivable	75,000	
Sales		75,000
Cost of Merchandise Sold	45,000	
Merchandise Inventory		45,000

Purchase on Account — Buyer

The buyer records:

Account	Debit	Credit
Merchandise Inventory	75,000	
Accounts Payable		75,000

> *The buyer does not know or record the seller's cost of ETB 45,000.*

Return — Seller and Buyer

Merchandise with a selling price of ETB 10,000 is returned. The seller's cost was ETB 6,000.

Seller

- Debit Sales Returns and Allowances 10,000
- Credit Accounts Receivable 10,000
- Debit Merchandise Inventory 6,000
- Credit Cost of Merchandise Sold 6,000

Buyer

- Debit Accounts Payable 10,000
- Credit Merchandise Inventory 10,000

Payment within the Discount Period

Amount owed after returns

ETB 65,000

Terms

2/10, n/30

Discount

65,000 × 2%

ETB 1,300

Cash

65,000 – 1,300

ETB 63,700

Settlement Entries

SELLER

Account	Debit	Credit
Cash	63,700	
Sales Discounts	1,300	
Accounts Receivable		65,000

BUYER

Account	Debit	Credit
Accounts Payable	65,000	
Merchandise Inventory		1,300
Cash		63,700

Section 8

Adjusting and Closing Process

Inventory Shrinkage

Inventory shrinkage is the difference between inventory shown by the accounting records and inventory actually found through physical count.

POSSIBLE CAUSES

Loss Events

- Shoplifting
- Employee theft
- Damage

Process Failures

- Recording errors
- Misplacement
- Spoilage

Inventory-Shrinkage Calculation

Inventory per records
ETB 382,800

Physical inventory
ETB 371,250

Shrinkage
382,800 – 371,250
ETB 11,550

Inventory-Shrinkage Adjustment

Account	Debit	Credit
Cost of Merchandise Sold	11,550	
Merchandise Inventory		11,550

> *After adjustment, the Merchandise Inventory account agrees with the physical count.*

Managing Inventory Shrinkage

Businesses can reduce shrinkage through:

Physical Controls

- Physical inventory counts
- Restricted warehouse access
- Security cameras
- Barcode systems

Process Controls

- Employee screening
- Segregation of duties
- Inventory reconciliations
- Investigation of unusual variances

Normal shrinkage is generally included in cost of merchandise sold; material abnormal losses may be separately reported.

Closing Accounts of a Merchandiser

Temporary accounts include:

Revenue and Contra-Revenue

- Sales
- Sales Returns and Allowances
- Sales Discounts
- Other revenues and expenses

Cost, Expense and Summary

- Cost of Merchandise Sold
- Operating expenses
- Owner's Drawing
- Income Summary

Closing Entry 1 — Credit-Balance Accounts

Assume Sales of ETB 900,000 and Rent Revenue of ETB 5,000.

Account	Debit	Credit
Sales	900,000	
Rent Revenue	5,000	
Income Summary		905,000

Closing Entry 2 — Debit-Balance Accounts

Assume: sales returns and allowances 25,000; sales discounts 10,000; cost of merchandise sold 570,000; operating expenses 180,000; interest expense 8,000.

Account	Debit	Credit
Income Summary	793,000	
Sales Returns and Allowances		25,000
Sales Discounts		10,000
Cost of Merchandise Sold		570,000
Operating expense accounts		180,000
Interest Expense		8,000

Closing Net Income and Drawing

Net income

905,000 – 793,000

ETB 112,000

CLOSE INCOME SUMMARY

Account	Debit	Credit
Income Summary	112,000	
Owner, Capital		112,000

CLOSE DRAWING OF ETB 30,000

Account	Debit	Credit
Owner, Capital	30,000	
Owner, Drawing		30,000

Periodic Inventory System Extension

Under the periodic inventory system:

Recording during the Period

- Purchases are recorded in Purchases
- Purchase returns are recorded separately
- Purchase discounts are recorded separately
- Freight in is recorded separately

At Period-End

- Cost of merchandise sold is not recorded at each sale
- A physical count is required
- Cost of merchandise sold is calculated after the count

Financial Analysis — Ratio of Net Sales to Assets

This ratio measures how effectively assets generate sales: Net Sales ÷ Average Total Assets.

Net sales
ETB 1,200,000

Beginning assets
ETB 700,000

Ending assets
ETB 800,000

Average assets
(700,000 + 800,000) ÷ 2
ETB 750,000

Ratio
1,200,000 ÷ 750,000
1.60 times

Section 9

Comprehensive Practical Exercise

Practical Exercise — Jigjiga Office Supplies

The following transactions occurred during May:

1. **Purchased merchandise on account for ETB 60,000, terms 2/10, n/30, FOB shipping point.**
2. **Paid freight of ETB 3,000.**
3. **Returned merchandise costing ETB 10,000.**
4. **Paid the supplier within the discount period.**
5. **Sold merchandise on account for ETB 80,000, terms 2/10, n/30; the merchandise cost ETB 48,000.**
6. **A customer returned merchandise sold for ETB 10,000; its cost was ETB 6,000.**
7. **The customer paid the remaining balance within the discount period.**
8. **Inventory records showed ETB 150,000, but physical inventory was ETB 147,500.**

Solution — Purchase Entries

PURCHASE AND FREIGHT

Account	Debit	Credit
Merchandise Inventory	60,000	
Accounts Payable		60,000
Merchandise Inventory	3,000	
Cash		3,000

RETURN TO SUPPLIER

Account	Debit	Credit
Accounts Payable	10,000	
Merchandise Inventory		10,000

Solution — Payment to Supplier

Amount due
60,000 – 10,000
ETB 50,000

Discount
50,000 × 2%
ETB 1,000

Cash paid
50,000 – 1,000
ETB 49,000

Account	Debit	Credit
Accounts Payable	50,000	
Cash		49,000
Merchandise Inventory		1,000

Solution — Sales Entries

SALE ON ACCOUNT

Account	Debit	Credit
Accounts Receivable	80,000	
Sales		80,000
Cost of Merchandise Sold	48,000	
Merchandise Inventory		48,000

CUSTOMER RETURN

Account	Debit	Credit
Sales Returns and Allowances	10,000	
Accounts Receivable		10,000
Merchandise Inventory	6,000	
Cost of Merchandise Sold		6,000

Solution — Collection from Customer

Remaining receivable
80,000 − 10,000
ETB 70,000

Discount
70,000 × 2%
ETB 1,400

Cash collected
70,000 − 1,400
ETB 68,600

Account	Debit	Credit
Cash	68,600	
Sales Discounts	1,400	
Accounts Receivable		70,000

Solution — Shrinkage and Gross Profit

Inventory shrinkage
150,000 – 147,500
ETB 2,500

Account	Debit	Credit
Cost of Merchandise Sold	2,500	
Merchandise Inventory		2,500

Net sales
80,000 – 10,000 – 1,400
ETB 68,600

Adjusted cost of merchandise sold
48,000 – 6,000 + 2,500
ETB 44,500

Gross profit
68,600 – 44,500
ETB 24,100

Chapter Summary — Concepts and Reporting

- Merchandising businesses purchase and resell merchandise.
- Merchandise Inventory is normally reported as a current asset.
- Cost of Merchandise Sold is matched against net sales.
- Gross profit equals net sales minus cost of merchandise sold.
- A multiple-step income statement reports gross profit and income from operations.
- The perpetual system continuously updates inventory and cost of merchandise sold.

Chapter Summary — Transactions and Adjustments

- Each sale normally requires a revenue entry and a cost entry.
- Sales returns and sales discounts reduce net sales.
- Purchase returns and purchase discounts reduce inventory cost under the perpetual system.
- FOB shipping point normally makes the buyer responsible for freight; FOB destination makes the seller responsible.
- Sales tax collected from customers is a liability.
- Trade discounts reduce the invoice price and are not recorded separately.
- Buyer and seller entries reflect the dual nature of merchandising transactions.
- Inventory shrinkage reduces inventory and increases cost of merchandise sold.
- Closing entries transfer revenue, contra-revenue, cost and expense balances to Income Summary.

Merchandising Profit Structure

- **Sales**
- Less sales returns and discounts
- Net sales
- Less cost of merchandise sold
- Gross profit
- Less operating expenses
- Income from operations
- Add or deduct other items
- **Net income**

Key Message

Successful merchandising accounting depends on accurately tracking both sides of every transaction: the revenue earned from customers and the cost of the merchandise that leaves inventory.

> *For a merchandising business, sales alone do not measure performance. Gross profit, inventory control, operating expenses and the accurate recording of purchases, returns, discounts and freight together determine the true financial result.*

Thank You

Questions and Discussion

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