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FINANCIAL ACCOUNTING

CHAPTER 5

Accounting for a Merchandising Business

LEARNING OBJECTIVES:

1. Describe the relationship among wholesalers, retailers, and customers
2. Define periodic and perpetual inventory systems
3. Journalize transactions for the purchase of inventory
4. Journalize transactions for the sale of inventory
5. Understand shipping terms, and journalize transactions for freight charges and other selling expenses
6. Prepare a multi-step income statement and a classified balance sheet
7. Compute the gross profit percentage and the current ratio

[New photo 5.1 a]

[New photo 5.1 b]

[New photo 5.1 c]

[New photo 5.1]

Although service businesses are the predominant type of business in Canada, they are not the only type. Canada also has a significant number of merchandising businesses. Maybe you are curious about how the accounting works for an organization that sells a product instead of a service? Do the financial statements that a merchandiser prepares differ from those of a service organization? In Chapter 5, you will discover the answers to these questions as we explore accounting for merchandise organizations.

CHAPTER OUTLINE:

WHAT IS THE RELATIONSHIP AMONG WHOLESALERS, RETAILERS, AND CUSTOMERS?

1 Describe the relationship among wholesalers, retailers, and customers

In this chapter, you will learn about the special accounting methods for a merchandising business. A merchandising business buys and sells products, called **merchandise inventory**, instead of services. Inventory is a very important asset to a merchandising business because it reflects the amount of goods the business has available to sell to its customers. Throughout the remainder of the book, we will refer to merchandise inventory simply as **inventory**.

A merchandising business can be either a wholesaler or a **retailer**. Wholesalers generally purchase large lots of products from manufacturers and resell them to retailers. Retailers buy goods from wholesalers and resell them to the final consumers, the general public. It is also possible for a retailer to purchase products directly from a manufacturer. Exhibit 5-1 shows the relationship among manufacturers, wholesalers, retailers, and customers.

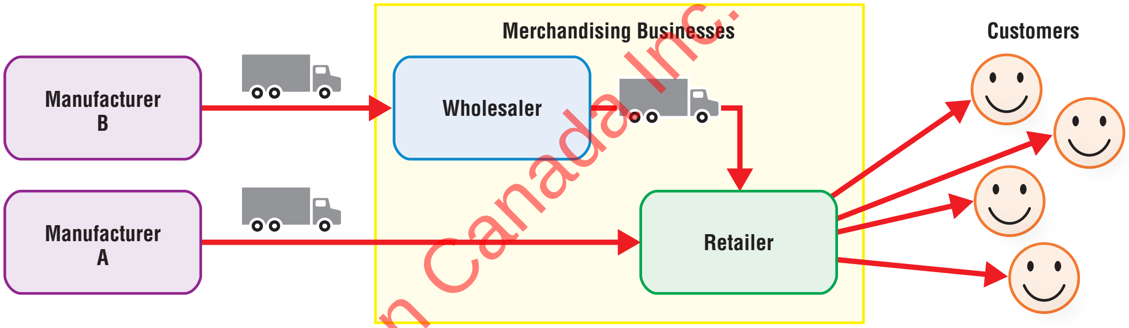


Exhibit 5-1

The discount chain Giant Tiger and the internet merchandiser Amazon.ca are familiar examples of retailers. In this chapter, a fictitious merchandiser named Cosmic Cellular, Inc. is used to illustrate merchandising operations. Cosmic Cellular is a mall retailer that sells cell phones and accessories. We will learn how Cosmic Cellular records entries related to purchases from its suppliers. In addition, we will learn the entries Cosmic uses to record sales of merchandise to its customers. We will also learn how the type of inventory tracking system chosen by Cosmic will impact the journal entries that it must make.

HOW DO PERIODIC AND PERPETUAL INVENTORY SYSTEMS DIFFER?

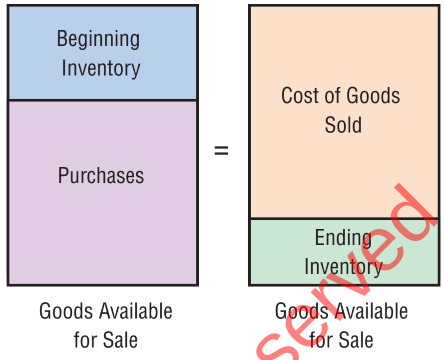
2 Define periodic and perpetual inventory systems

Merchandisers use one of two inventory tracking systems:

- The **periodic inventory system** is a system of accounting for inventory that does *not* keep a continuous, running record of inventory as it is bought and sold. Instead, the business physically counts the goods in inventory at the end of the accounting period. It then multiplies the quantity of each item by its cost to get the total value of the ending inventory. Once the ending inventory has been determined, a business will calculate the cost of the inventory it has sold during the period. **Exhibit 5-2** shows the components of inventory activities, and the schedule of cost of goods sold is calculated using these components.

Historically, businesses that sold large quantities of relatively inexpensive goods used the periodic inventory system because it was too costly and time consuming to track the inventory items that were sold. Currently, thanks to innovations in inventory tracking technology, most businesses utilize a perpetual inventory system.

- The **perpetual inventory system** is a system of accounting for inventory that keeps a running record of inventory as it is bought and sold. Every time the business engages in a transaction involving inventory, the balance in the inventory account is immediately updated. By doing this, the inventory balance is *perpetually* up-to-date. However, the business must still physically count inventory at least once a year to see whether any goods have been lost, damaged, or stolen. Just because the accounting records indicate that a certain amount of inventory exists, it doesn't mean that this amount is actually on hand. If the actual inventory count is different than the perpetual records indicate, the perpetual records are adjusted to reflect the physical count. The general ledger is also updated by debiting or crediting the inventory account as needed. The offsetting debit or credit is to the Cost of Goods Sold account. Technology makes it easier for almost any business to use the perpetual system. Usually, a cash register used in a perpetual system is connected to a bar code scanner. When an inventory item is scanned, not only is the sale recorded, but the inventory records are simultaneously updated.



Beginning Inventory
+ Purchases
= Cost of Goods Available for Sale
− Ending Inventory
= Cost of Goods Sold

Exhibit 5-2

DECISION GUIDELINES

Decision	Guideline	Analyze
Which inventory system should my business use?	This decision depends on whether or not you plan on utilizing a computer system to help with inventory management.	TThe *perpetual system* shows the current, correct amounts of inventory on hand and the cost of goods sold at all times. The *periodic system* requires that a physical count of the inventory be taken to know the correct balances of inventory and cost of goods sold. Before computers, only businesses that sold smaller quantities of higher cost items could use the perpetual method. Today, thanks to computers and other technology, most companies utilize the perpetual method even if they sell a high quantity of low-cost items.

HOW DO YOU ACCOUNT FOR THE PURCHASE OF INVENTORY?

3 Journalize transactions for the purchase of inventory

Throughout the year, merchandisers engage in a number of inventory transactions with suppliers including cash purchases, credit purchases, **purchase returns and allowances**, and **purchase discounts**. Depending on the inventory system the merchandiser uses, the recording of the purchase of inventory and the sale of inventory are accounted for differently. Since the periodic inventory does not require constant updating of the inventory level, we use separate accounts for recording purchases, purchase returns and allowances, transportation-in, and purchase discounts. On the other hand, the perpetual inventory system requires updating the inventory account balance, so when inventory is purchased, we need to increase inventory, and when inventory is sold, we also need to decrease inventory. Let's examine how Cosmic Cellular accounts for these types of transactions.

Cash and Credit Purchases

Cosmic Cellular purchases 300 cell phone cases from Accessories Unlimited on account at a cost of \$25 each. Therefore, the total value of Cosmic's purchase is \$7,500 (300 cases × \$25). Cosmic Cellular receives the goods on February 1 and records this purchase as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 1	Inventory	7,500	
	Accounts Payable—Accessories Unlimited		7,500
	Record purchase of inventory on account.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 1	Purchases	7,500	
	Accounts Payable—Accessories Unlimited		7,500
	Record purchase of inventory on account.		

Using the perpetual inventory system, the purchase of inventory on account increases both Cosmic Cellular's assets and liabilities. The Inventory account reflects the cost of goods purchased for resale. The balance increases every time inventory is purchased. Inventory is an asset until it is sold because, as discussed in Chapter 1, assets represent things of value that the business has. Using the periodic inventory system, the purchase of inventory does not increase assets, as the Inventory account is not updated. Instead, the purchases account, which is one of the cost of goods sold accounts, is increased. This amount will be used to calculate the overall cost of goods sold for the period.

Notice that the name of the supplier is listed in the journal entry following Accounts Payable. The supplier's name is used because the amount owed to each individual supplier will be posted to a **subsidiary ledger** in addition to the Accounts Payable account in the general ledger. The subsidiary ledger contains a record for each separate supplier. If everything has been posted correctly, the total of the account balances in the accounts payable subsidiary ledger will equal the Accounts Payable account balance in the general ledger. This way, a merchandiser can keep track of the amount of accounts payable owed to each individual supplier.

Some suppliers may require cash to be paid at the time of shipment. If Accessories Unlimited required cash payment for the 300 cell phone cases at the time of sale, Cosmic Cellular would record the cash purchase as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 1	Inventory	7,500	
	Cash		7,500
	Record purchase of inventory for cash.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 1	Purchases	7,500	
	Cash		7,500
	Record purchase of inventory for cash.		

Purchase Returns and Allowances

Occasionally, merchandisers buy goods that are not satisfactory. In these cases, most suppliers allow the goods to be returned. Or, they may allow the merchandiser to keep the unsuitable goods and receive a deduction, or allowance, from the amount they owe for the merchandise. Both purchase returns and allowances decrease the merchandiser's cost of the inventory.

Suppose Cosmic Cellular buys 20 hands-free headsets for $20 each from Mega Mobile, and these headsets become damaged in shipment. If Cosmic returns the merchandise to Mega Mobile, it will issue a **debit memorandum**. A debit memorandum is a document that supports the return of goods to the supplier, as illustrated in **Exhibit 5-3**.

COSMIC CELLULAR
1471 Front St.
Toronto, Ontario

DEBIT MEMORANDUM #47

To: Mega Mobile
21 Dundas Street
Hamilton, Ontario

Date: April 5, 2013

We debit your account balance for the following:

20 T180 Headsets @ $20 each	**$400**

Exhibit 5-3

A debit memorandum gets its name from the fact that the issuer's Accounts Payable account will be debited as a result of the return of the goods. Upon issuing the debit memorandum, Cosmic will *debit*, or reduce, its Accounts Payable balance for the value of the merchandise returned. Cosmic will also reduce the inventory account by the amount of the return because it no longer has this inventory. Cosmic records the purchase return as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Apr 5	Accounts Payable—Mega Mobile	400	
	Inventory		400
	Record inventory returned to manufacturer.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Apr 5	Accounts Payable—Mega Mobile	400	
	Purchase Returns and Allowances		400
	Record inventory returned to manufacturer.		

Purchase Discounts

Exhibit 5-4 on the following page illustrates Accessories Unlimited's invoice for Cosmic's $7,500 purchase of inventory. A **sales invoice** is a bill that documents the sale of goods to a business customer. The invoice includes **credit terms**, or the payment terms, for customers who buy on account. A customer may pay cash when it receives the goods or it may pay within a period of time following the receipt of those goods. Merchandisers use credit terms on sales to communicate to the customer when payment is due. Often, merchandisers will use the term **n/30**, which means that the sales price for the goods must be paid within 30 days after the date of the invoice. If the amount is due at the end of the month, the invoice will include the phrase **n/eom** or just **eom**.

All businesses want to have enough cash to pay their bills on time. Therefore, suppliers often offer merchandisers purchase discounts for early payment to improve their cash inflow.

Accessories UNLIMITED
Accessories Unlimited
P.O. Box 873
Windsor, Ont.

Invoice	
Date	Number
2/1/13	644

Shipped to: Cosmic Cellular
1471 Front St.
Toronto, Ontario

Terms: 3/15, n/30

Quantity	Item	Unit Price	Total
300 each	Cell phone cases	$ 25	$ 7,500

Subtotal	$ 7,500
Shipping Charge	–
Tax	–
Total	$ 7,500

Exhibit 5-4

By rewarding the merchandiser for paying amounts before the due date, these companies get cash sooner. The time period in which the merchandiser may pay and receive the discount is called the **discount period**. If the merchandiser takes advantage of this offer and pays early, then these discounts represent a reduction in the cost of the merchandise purchased.

Review Accessories Unlimited's invoice in Exhibit 5-4. Accessories Unlimited's credit terms of "3/15, n/30" mean that Cosmic Cellular may deduct 3% of the total amount due to Accessories Unlimited if it pays within 15 days of the invoice date. Otherwise, the full amount is due in 30 days. In this case, the discount period covers 15 days. However, if Accessories Unlimited listed terms of "n/30" instead of "3/15, n/30," it would mean that it was not offering a discount at all, and payment is due 30 days after the invoice date.

If Cosmic Cellular pays within the discount period, it will pay $7,275, or 97% of the purchase invoice amount of $7,500:

Invoice Total	$7,500	(100% of invoice amount)
– Purchase Discount	(225)	(3% of invoice amount, or .03 × $7,500)
= Cash Paid	$7,275	(97% of invoice amount, or .97 × $7,500)

Cosmic records its payment on February 13, which is within the discount period, as shown:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 13	Accounts Payable—Accessories Unlimited	7,500	
	Cash		7,275
	Inventory		225
	Record payment of inventory purchases within the discount period.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 13	Accounts Payable—Accessories Unlimited	7,500	
	Cash		7,275
	Purchase Discount		225
	Record payment of inventory purchases within the discount period.		

In the perpetual inventory system, the discount is credited to the Inventory account. This is because the discount decreases the cost of the cell phone cases that Cosmic Cellular bought from Accessories Unlimited. Using the periodic inventory system, the discount taken is credited directly to the Purchase Discount account, a contra purchases account. Note that the full invoice amount of the payable, $7,500, should be debited, rather than the net amount of $7,275; otherwise, the Accounts Payable—Accessories Unlimited account will show an outstanding amount of $225.

If Cosmic Cellular pays this invoice after the discount period, it pays the full amount of $7,500. In this case, it records the payment as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 13	Accounts Payable—Accessories Unlimited	7,500	
	Cash		7500
	Record payment of inventory purchases after the discount period.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 13	Accounts Payable—Accessories Unlimited	7,500	
	Cash		7,500
	Record payment of inventory purchases after the discount period.		

It is important to note that discounts are not granted on any portion of a purchase that is returned to the supplier. For example, if Cosmic Cellular returned four damaged cell phone cases at $25 each to Accessories Unlimited on February 3, the balance owed to Accessories Unlimited on February 13 before the payment was made would be $7,400. Cosmic records the purchase returns on February 3 and payment on February 13, which is within the discount period, as shown:

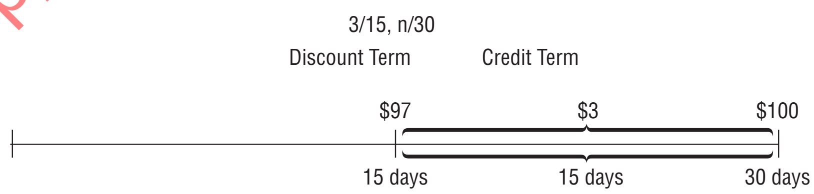
Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 3	Accounts Payable—Accessories Unlimited	100	
	Inventory		100
	Record inventory returned to manufacturer.		
Feb 13	Accounts Payable—Accessories Unlimited	7,400	
	Cash		7,178
	Inventory		222
	Record payment of inventory purchases within the discount period.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 3	Accounts Payable—Accessories Unlimited	100	
	Purchase Returns and Allowances		100
	Record inventory returned to manufacturer.		
Feb 13	Accounts Payable—Accessories Unlimited	7,400	
	Cash		7,178
	Purchase Discount		222
	Record payment of inventory purchases within the discount period.		

Many companies take advantage of this discount, if they have cash or have access to cash to pay the invoice within 15 days. In fact, the effective interest rate is approximately 75%. This interest rate is calculated by taking $3 on the balance owing of $97; in other words, if $97 is not paid within 15 days, then there is a $3 interest charge for the additional 15 days. In fact, if companies can borrow money at a lower rate to pay for the purchase and pay back the borrowed amount by the 30th day, then they manage their cash flows and operations effectively.



$\$3 \div \$97 = 3.09\%$ for 15 days $3.09\% \div 15$ days $= 0.206\%$ per day

$0.206\% \times 365$ days $= 75.26\%$ per year

Period-End Cost of Goods Sold and Inventory Adjustments

Under the perpetual inventory system, we use the cost of goods sold and inventory accounts to account for all the purchases, purchase returns, sales, and sales returns; therefore, the cost of goods sold and inventory should be up to date, and there should be no need for period-end adjustments. However, under the perpetual inventory system, the cost of goods sold and inventory accounts have not been updated for the entire accounting period. We need to calculate the cost of goods sold and to update the inventory account balance. For example, Cosmic Cellular's ledger shows the following account balances on December 31, 2013:

ACCOUNT #	ACCOUNT TITLE	DR.	CR.
1030	Inventory	35,800	
5020	Purchases	80,500	
5030	Purchases Returns and Allowances		7,500
5040	Purchase Discounts		2,500
5050	Transportation-in	12,000	

And the year-end inventory physical count shows the inventory is $28,000. The cost of goods sold is calculated as follows:

Beginning Inventory		$ 35,800
+ Purchases	$80,500	
– Purchase Returns and Allowances	(7,500)	
– Purchase Discounts	(2,500)	
+ Transportation-in	12,000	
= Total Cost of Goods Purchased		82,500
Goods Available for Sale		$118,300
– Ending Inventory		(28,000)
= Cost of Goods Sold		$ 90,300

Two period-end adjusting entries are required to close the beginning inventory and all purchase-related accounts to the Cost of Goods Sold account and to update the inventory balance. Once these two entries are recorded, both the Cost of Goods Sold account ($90,300) and Inventory ($28,000) accounts are updated.

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Dec 31	No entry		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Dec 31	Cost of Goods Sold	128,300	
	Inventory		35,800
	Purchases		80,500
	Transportation-in		12,000
	To close beginning Inventory, Purchases, and Transportation-in to the Cost of Goods Sold account		
Dec 31	Inventory	28,000	
	Purchase Returns and Allowances	7,500	
	Purchase Discounts	2,500	
	Cost of Goods Sold		38,000
	To update ending Inventory, close Purchase Returns and Allowance and Purchase Discount accounts to the Cost of Goods Sold account		

HOW DO YOU ACCOUNT FOR THE SALE OF INVENTORY?

4 Journalize transactions for the sale of inventory

Merchandisers engage in several different types of business transactions with customers:

- Cash sales: Goods are sold for cash.
- Credit sales: Goods are sold on account.
- Sales returns and allowances: Damaged goods are returned by a customer for a refund. However, sometimes the customer keeps the damaged goods and accepts an allowance (price reduction) on the goods.
- Sales discounts: Suppliers grant customers a reduction in the amount owed as an incentive for paying within a discount period.

Let's examine how Cosmic Cellular accounts for these types of transactions.

Cash Sales

Merchandisers, such as Cosmic Cellular, often receive cash at the time they sell merchandise. The journal entry to record a cash sale increases the asset Cash, and increases the revenue account, **Sales Revenue**. Sales Revenue is the account used by merchandisers to track the value of merchandise sold to customers at the price that the merchandiser charges those customers.

Using the periodic system, Cosmic Cellular only requires recording the sales, since the reduction of inventory is not updated. However, using the perpetual inventory system, Cosmic Cellular not only needs to account for the sales, but also to reduce the Inventory balance for the value of the merchandise sold. By doing this, the Inventory account is updated so that it always, or perpetually, reflects the current balance. The value of the merchandise sold is accounted for in the **Cost of Goods Sold** account. This income statement account reflects the cost of merchandise sold during the period. The Cost of Goods Sold is deducted from Sales Revenue as a step in determining the amount of net income or loss for the period.

Assume that on June 9, Cosmic Cellular sells $3,000 of merchandise to customers for cash. The goods that Cosmic sold its customers cost Cosmic $1,900. The journal entry to record the sale is as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Jun 9	Cash	3,000	
	Sales Revenue		3,000
	Cost of Goods Sold	1,900	
	Inventory		1,900
	Record sale of inventory for cash.	1,900	

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Jun 9	Cash	3,000	
	Sales Revenue		3,000
	Record sale of inventory for cash.		

Using the perpetual inventory system, when a product is sold, a merchandiser recognizes the following:

1. Sales revenue for the selling price of the product to the customer
2. Cost of goods sold for the merchandiser's cost of the product

A journal entry that involves more than two accounts is called a compound journal entry. A compound entry may include more than one debit amount or more than one credit amount.

Some merchandisers allow customers to use credit cards and debit cards rather than currency. These transactions are treated as cash sales because the merchandiser receives cash from the credit/debit card company within a short period of time. The credit/debit card company then collects the amount due from the customer. The merchandiser, however, usually must pay a service charge to the credit/debit card company in exchange for its processing of the transactions. Accounting for debit and credit card sales is discussed in Chapter 7 in more detail.

Credit Sales

Many merchandisers establish charge accounts for their customers. Assume that Cosmic Cellular sold on account a cell phone and accessories to Jim Kahl on June 11 for $500. The goods cost Cosmic $290. The entry to record this transaction is similar to accounting for a cash sale except Accounts Receivable is debited instead of Cash. Cosmic records this sale on account as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Jun 11	Accounts Receivable—Jim Kahl	500	
	Sales Revenue		500
	Cost of Goods Sold	290	
	Inventory		290
	Record sale of inventory on account, invoice no. 322.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Jun 9	Accounts Receivable—Jim Kahl	500	
	Sales Revenue		500
	Record sale of inventory on account, invoice no. 322.		

When Jim sends Cosmic his payment for this merchandise, Cosmic records the cash receipt on account as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Jun 19	Cash	500	
	Accounts Receivable—Jim Kahl		500
	Record payment received on invoice no. 322.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Jun 19	Cash	500	
	Accounts Receivable—Jim Kahl		500
	Record payment received on invoice no. 322.		

Notice that the name of the customer is listed in the journal entry following Accounts Receivable. This is similar to what is done for Accounts Payable. A separate account is kept in an accounts receivable subsidiary ledger for each charge customer. Each entry affecting accounts receivable is posted to the customer's account in the subsidiary ledger as well as to the Accounts Receivable account in the general ledger. After all entries are posted, the total of the account balances in the accounts receivable subsidiary ledger will equal the Accounts Receivable account balance in the general ledger. This way, the merchandiser can keep track of the amount of accounts receivable owed by each individual customer.

Sales Returns and Allowances

Merchandisers may allow customers to return unwanted merchandise or they may let customers keep the goods and request an allowance. A business tracks these returns so that it can analyze and manage the causes behind the returns and measure the related costs to the business. To track returns accurately, the amount of returns is recorded in a contra-account called **Sales Returns and Allowances**. Remember from Chapter 3 that a contra-account is an account with a balance opposite of the account to which it is linked. Sales Returns and Allowances is linked to Sales Revenue, which has a credit balance. Therefore, Sales Returns and Allowances will have a debit balance. As we will see later, Sales Returns and Allowances appears on the income statement and is deducted from Sales Revenue to arrive at Net Sales.

Exhibit 5-5 illustrates a **credit memorandum**, a document that acknowledges the return of goods from a customer. The credit memo gets its name from the effect that it has on the balance of the customer's account. Because the credit memo decreases the amount due from the customer, the merchandiser *credits* the accounts receivable balance for that customer. The merchandiser sends a credit memorandum to the customer as notification that an adjustment has been made to the amount the customer owes the merchandiser.

COSMIC CELLULAR
1471 Front St.
Toronto, Ontario

CREDIT MEMORANDUM #14

To: Jill Harris
28 St. George St.
Calgary, Alberta

Date: August 15, 2013

We credit your account balance for the following:

3 car chargers @ $25 each	**$75**

Exhibit 5-5

Sales Returns

When a customer returns goods, the merchandiser will

- decrease net sales revenue by increasing Sales Returns and Allowances, and decrease the customer's Accounts Receivable account balance for the sales price of those goods.
- decrease Cost of Goods Sold and increase Inventory for the cost of the returned goods, if the perpetual inventory system is used. No inventory adjustment is required for the periodic inventory system, when the goods are returned. The adjustment will be done at the end of the accounting period, when the inventory physical count takes place.

Let's see how Cosmic records the return illustrated in the credit memo in Exhibit 5-5. The credit memo reflects the return of three car chargers, originally purchased for $75, by Jill Harris, a customer. The returned car chargers cost Cosmic $30. Cosmic Cellular records the sales return as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Aug 15	Sales Returns and Allowances	75	
	Accounts Receivable—Jill Harris		75
	Inventory	30	
	Costs of Goods Sold		30
	Record receipt of returned goods, credit memo no. 14.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Aug 15	Sales Returns and Allowances	75	
	Accounts Receivable—Jill Harris		75
	Record receipt of returned goods, credit memo no. 14.		

Accounts Receivable decreases because the customer no longer owes Cosmic for the returned goods. In the perpetual system only, Cosmic also updates its inventory because its perpetual inventory system needs to reflect the increase to Inventory because of the return of the goods. Cosmic also decreases the Cost of Goods Sold because the goods are no longer sold.

Sales Allowances

Rather than return goods to the merchandiser, some customers may be willing to keep unwanted goods and accept an allowance. Assume Cosmic Cellular grants credit customer Bill Logan a $100 sales allowance for damaged goods. Cosmic records the sales allowance as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Aug 15	Sales Returns and Allowances	100	
	Accounts Receivable—Bill Logan		100
	Record sales allowance for damaged goods, credit memo no. 15.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Aug 15	Sales Returns and Allowances	100	
	Accounts Receivable—Bill Logan		100
	Record sales allowance for damaged goods, credit memo no. 15.		

Notice that the journal entry for a sales allowance does not affect Inventory or Cost of Goods Sold because the customer did not return any goods to the merchandiser.

Sales Discounts

Do you recall the discount that Cosmic Cellular received from Accessories Unlimited for early payment? It is possible for Cosmic to offer discounts to its credit customers for early payment. Let's assume that Cosmic sells merchandise to Kelly Harding for $450. The sale is made on account with credit terms of 2/15, n/30. If Kelly chooses to pay the invoice within the 15-day discount period, she will get a 2%, or $9, discount on her $450 purchase ($450 × 0.02). Kelly will pay $441, or 98% of the invoice amount of $450. This discount represents a reduction in the value of sales to Cosmic.

Businesses track the amount of these sales discounts so they can measure the impact on their sales revenue. To do so, businesses record these discounts in a contra-account called **Sales Discounts**. Because Sales Discounts is linked to Sales Revenue, it will normally have a debit balance. The Sales Discounts account tracks decreases in sales revenue that result from a discount to customers. Similar to the treatment of Sales Returns and Allowances, Sales Discounts appears on the income statement and is deducted from Sales

CONCEPT CHECK

If a customer returned $2,500 of merchandise and the transaction was recorded by debiting Sales and crediting Accounts Receivable, instead of debiting Sales Returns and Allowances and crediting Accounts Receivable, would the net income on the income statement be incorrect?

Answer:

No. Let's assume that the company has $20,000 of total sales at the time the return is made and that this is the first time merchandise is returned during the period. If the transaction is recorded by debiting Sales, the Sales balance will be reduced to $17,500. Because there have been no other sales returns, the balance in the Sales Returns and Allowances will be zero. Therefore, the amount of net sales will be $17,500. If, instead of debiting Sales, the Sales Returns and Allowances account is debited, the Sales account will have a balance of $20,000 and the Sales Returns and Allowances account will have a balance of $2,500. Therefore, the amount of net sales will still be $17,500 ($20,000 – $2,500). If the amount of net sales is $17,500 regardless of which way the transaction is recorded, the net income will be the same. The reason for using the Sales Returns and Allowances account is simply to keep track of the amount of merchandise returned during the period. Managers often use this information to determine if there are quality issues with their products.

Revenue to arrive at net sales. Because the Sales Returns and Allowances and the Sales Discount accounts have debit balances, they will be closed along with the expense accounts at the end of the period.

Assume that Cosmic receives payment of $441 from Kelly on February 13 within the discount period. The journal entry to record the receipt of cash and the sales discount is as follows:

DATE	ACCOUNTS	DR.	CR.
Feb 13	Cash	441	
	Sales Discounts	9	
	Accounts Receivable—Kelly Harding		450

If Kelly fails to pay within the 15-day discount period, she will have to pay the full invoice price of $450. If Cosmic receives payment from Kelly on February 24, it records the payment as follows:

DATE	ACCOUNTS	DR.	CR.
Feb 24	Cash	450	
	Accounts Receivable—Kelly Harding		450

Notice that there is no entry for inventory because this is a receipt of payment from the customer.

HOW DO YOU ACCOUNT FOR FREIGHT CHARGES AND OTHER SELLING EXPENSES?

5 Understand shipping terms, and journalize transactions for freight charges and other selling expenses

In addition to purchases and sales transactions, a merchandiser also accounts for shipping costs and other selling expenses. Merchandisers often pay costs related to

- receiving goods from suppliers.
- delivering goods to customers.
- advertising and other selling costs.

When merchandisers order items, they often pay the cost of shipping the items to their place of business. These shipping costs are often referred to as **freight charges**.

ACCOUNTING IN YOUR WORLD

Have you ever purchased something online, or from a catalogue, and thought you received a really great deal until you received the bill and realized that the company charged you a significant amount for "shipping and handling"? The reason that you were required to pay these shipping charges is because the merchandise was sold with shipping terms of "FOB Shipping Point." Next time, you should purchase items from a company that offers "FOB Destination" shipping terms.

Buyers and sellers specify who pays shipping costs by agreeing to shipping terms. In addition to dictating who is responsible for paying shipping costs, shipping terms also specify the point at which ownership of the goods, or **title**, transfers from seller to buyer. Shipping terms may be **free on board (FOB) shipping point** or **free on board (FOB) destination**.

- Under free on board (FOB) shipping point, ownership transfers from the seller to the buyer at the point where the goods are *shipped*. Also, this term means that the buyer pays the shipping charges to have the merchandise delivered to their place of business. The buyer adds the shipping costs to inventory by debiting Inventory because these amounts increase the cost of the goods purchased.

- Free on board (FOB) destination denotes the opposite arrangement. Ownership transfers from the seller to the buyer when the goods reach their *destination*. This term means that the seller must pay to ship goods to that point. The seller records the shipping costs with a debit to Delivery Expense.

Exhibit 5-6 summarizes FOB terms.

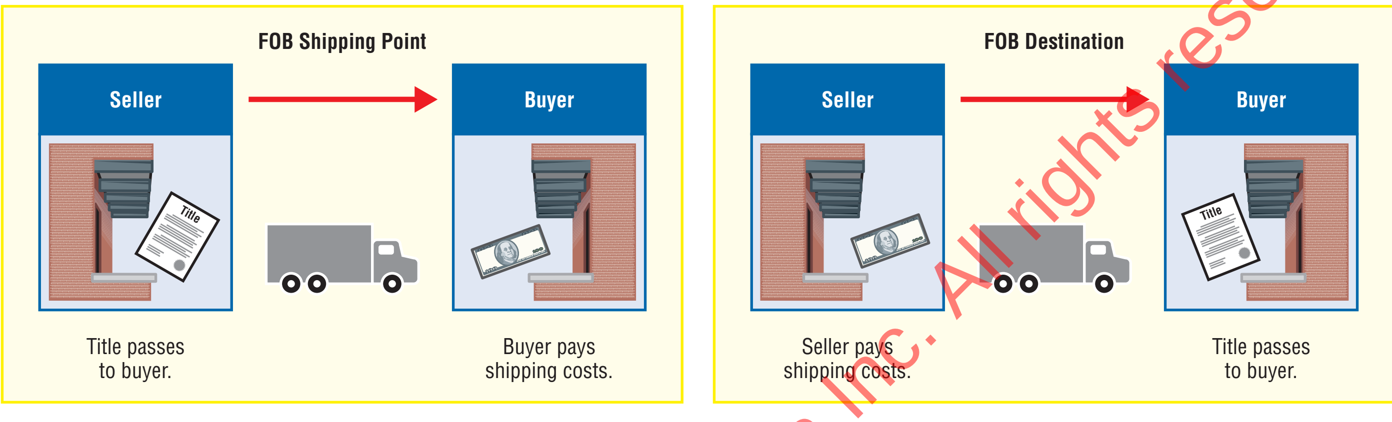


Exhibit 5-6

Costs Related to the Receipt of Goods from Suppliers

Let us see how Cosmic Cellular records shipping costs when it purchases goods. When it buys products under FOB shipping point, Cosmic either pays the shipping company directly or reimburses the seller for the freight charges if they have been prepaid by the seller. When Cosmic buys products under FOB destination, the supplier pays the freight charges.

FOB Shipping Point, Pay the Shipping Company

Suppose Cosmic Cellular incurs shipping costs related to the purchase of merchandise (FOB shipping point) from Accessories Unlimited. Cosmic pays $60 to the carrier for the February 1 shipment. Cosmic Cellular's entry to record payment of the shipping charge is as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 1	Inventory	60	
	Cash		60
	Record payment of shipping bill for the February 1 purchase.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Feb 1	Transportation-in	60	
	Cash		60
	Record payment of shipping bill for the February 1 purchase.		

Note that under the perpetual inventory system, the shipping cost is debited in the Inventory account, as the cost of the inventory is increased. However, under the periodic inventory system, the shipping cost is recorded in the Transportation-In account, which is one of the cost of goods sold accounts.

FOB Shipping Point, Repay the Seller for Prepaid Shipping Costs

Under FOB shipping point, the seller sometimes prepays the shipping costs as a convenience to the buyer. These costs are added to the invoice for the merchandise.

Let's see how Cosmic records the following purchase transactions. On July 15, Cosmic buys $1,000 of goods on account from CellTel, Inc. The terms of the purchase are 2/10, n/30, FOB shipping point. CellTel prepaid $80 of shipping costs and added the charges to the invoice for an invoice total of $1,080. Cosmic then returns $100 of these goods for credit on July 20. On July 25, Cosmic makes payment in full for the purchase.

First, Cosmic records the purchase of goods:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Jul 15	Inventory	1,080	
	Accounts Payable—CellTel, Inc.		1,080
	Record purchase of inventory on account.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Jul 15	Purchases	1,080	
	Accounts Payable—CellTel, Inc.		1,080
	Record purchase of inventory on account.		

Next, Cosmic records the return of inventory, as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Jul 20	Accounts Payable—CellTel, Inc.	100	
	Inventory		100
	Record inventory returned to the manufacturer.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Jul 20	Accounts Payable—CellTel, Inc.	100	
	Purchase Returns and Allowances		100
	Record inventory returned to the manufacturer.		

Finally, it records the payment for the purchase by calculating the purchase discount and the balance due. Cosmic pays on July 25, which is within the 10-day discount period, so it receives a discount of $18: 2% of the $1,000 original cost of the goods minus $100 of returned goods, or 0.02 × $900. Although shipping costs increase the invoice amount of the merchandise purchased, they are not included in the calculation of any purchase discount. The purchase discount is computed only on the amount due to the supplier for the goods purchased. The calculation of the payment amount is as follows:

Purchase Amount	$1,000
+ Shipping Costs	80
– Purchase Return	(100)
– Purchase Discount	(18) ($1,000 – $100 = $900; $900 × 0.02 = $18)
= Cash Paid	$ 962

The journal entry to record the cash payment is as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Jul 25	Accounts Payable—CellTel, Inc.	980	
	($1,000 + $80 – $100)		
	Inventory [($1,000 – $100) × 0.02]		18
	Cash ($1,000 + $80 – $100 – $18)		962
	Record payment of inventory purchases within the discount period.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Jul 25	Accounts Payable—CellTel, Inc.	980	
	($1,000 + $80 – $100)		
	Purchase Discounts [($1,000 – $100) × 0.02]		18
	Cash ($1,000 + $80 – $100 – $18)		962
	Record payment of inventory puchases within the discount period.		

FOB Destination

Under FOB destination, the seller pays to ship the goods to the destination requested by the customer. If Cosmic Cellular purchased goods under these terms, it has no shipping costs to record because the supplier pays the freight.

Costs Related to Delivering Goods to Customers

The cost of shipping goods to customers is recorded in an expense account titled Delivery Expense. This cost occurs when the seller agrees to shipping terms of FOB destination. Delivery Expense is an expense on the income statement and, as an expense account, normally has a debit balance.

Let's see how the sale of goods and payment of shipping costs affect Cosmic Cellular in different situations. Rob Macklin, a frequent customer at Cosmic Cellular, has an account with the store. Rob buys a Bluetooth headset as a Christmas gift for his sister who lives in Vancouver. Cosmic purchases the head set for $45 and sells it to Rob for $100. Shipping costs to Vancouver total $15.

FOB Destination

Let's assume that Cosmic advertises that shipping costs are free with any purchase of $100 or more. Assume Rob buys the headset on November 30 and charges it to his account. He asks Cosmic to ship it to Vancouver. Cosmic records the sale and payment of shipping costs as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	100	
	Sales Revenue		100
	Cost of Goods Sold	45	
	Inventory		45
	Record sale of inventory on account.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	100	
	Sales Revenue		100
	Record sale of inventory on account.		

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Delivery Expense	15	
	Cash		15
	Record shipping on sale.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Delivery Expense	15	
	Cash		15
	Record shipping on sale.		

In this case, income from the sale is $40 ($100 – $45 – $15).

FOB Shipping Point

Now, let's assume that Cosmic does not offer free shipping. Because Cosmic sold the goods FOB shipping point, Rob pays for the shipping costs. Rob purchases the headset on November 30 and takes it home to wrap and send with another gift. Cosmic would record the sale as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	100	
	Sales Revenue		100
	Cost of Goods Sold	45	
	Inventory		45
	Record sale of inventory on account.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	100	
	Sales Revenue		100
	Record sale of inventory on account.		

In this situation, income from the sale would be $55 ($100 – $45).

FOB Shipping Point, Seller Agrees to Prepay the Shipping Costs

Now assume that Rob buys the headset on November 30 and asks Cosmic to ship it to Vancouver for him. Again, because the goods are sold FOB shipping point, Rob is responsible for the shipping charges. In this case, Cosmic pays for shipping the goods and adds the cost to Rob's invoice. Cosmic records the sale, including the payment of shipping costs, as follows:

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	100	
	Sales Revenue		100
	Cost of Goods Sold	45	
	Inventory		45
	Record sale of inventory on account.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	100	
	Sales Revenue		100
	Record sale of inventory on account.		

Perpetual Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	15	
	Cash		15
	Record prepayment of shipping costs.		

Periodic Inventory System

DATE	ACCOUNTS	DR.	CR.
Nov 30	Accounts Receivable—Rob Macklin	15	
	Cash		15
	Record prepayment of shipping costs.		

Income from the sale is again $55 ($100 – $45). The $15 Cosmic paid to ship the headset to Vancouver is not an expense as it will be reimbursed by Rob. A comparison reveals that the income from the sale under FOB shipping point remains the same whether or not Cosmic prepays the shipping charges:

	FOB destination	FOB Shipping Point	FOB Shipping Point, Seller Prepays
Sales Revenue	$100	$100	$100
– Cost of Goods Sold	(45)	(45)	(45)
– Delivery Expense	(15)	—	—
= Income from Sale	$ 40	$ 55	$ 55

Other Selling Costs

Selling expenses represent the costs associated with advertising and selling inventory. Examples of selling expenses usually found on a merchandiser's income statement include the following:

- Sales salaries, wages, and commissions
- Advertising and promotion
- Depreciation for the use of stores, parking lots, counters, displays, shelves, vehicles of salespeople, and storage space (such as warehouses and refrigerators)
- Delivery of merchandise to customers

As we will see in the next section, selling expenses are a deduction when arriving at the net income of a merchandiser.

Exhibit 5-7 summarizes the comparison of the purchases-related journal entries using the perpetual inventory system and the periodic inventory system:

Perpetual Inventory System	DR.	CR.	Periodic Inventory System	DR.	CR.
Inventory	xxxx		Purchases	xxxx	
Accounts Payable		xxxx	Accounts Payable		xxxx
Record purchase of inventory on account.			Record purchase of inventory on account.		
Accounts Payable	xx		Accounts Payable	xx	
Inventory		xx	Purchase Returns and Allowances		xx
Record inventory returned to manufacturer.			Record inventory returned to manufacturer.		
Inventory	xx		Transportation-in	xx	
Cash		xx	Cash		xx
Record payment for transportation			Record payment for transportation		
Accounts Payable	xxxx		Accounts Payable	xxxx	
Inventory		xx	Purchase Discounts		xx
Cash		xxxx	Cash		xxxx
Record payment of inventory purchases within the discount period.			Record payment of inventory purchases within the discount period.		

Exhibit 5-7

Note that when using the perpetual inventory system, the Inventory account is used to record Purchases, Purchase Returns and Allowances, Purchase Discounts, and Transportation-in; when using the periodic inventory system, all the purchase-related activities are recorded in separate accounts.

Exhibit 5-8 summarizes the comparison of the sales-related journal entries using the perpetual inventory system and the periodic inventory system:

Step 1 Perpetual Inventory System AND Periodic Inventory System	DR.	CR.	Step 2 Perpetual Inventory System Only (Inventory Adjustments)	DR.	CR.
Accounts Receivable	xxxx		Cost of Goods Sold	xxxx	
Sales		xxxx	Inventory		xxxx
To record the sales of inventory			To record the purchase of inventory		
Sales Returns and Allowances	xx		Inventory	xx	
Accounts Receivable		xx	Cost of Goods Sold		xx
Record receipt of returned goods			Record receipt of returned goods		
			No entry if goods are defective		
Cash	xxxx				
Sales Discounts	xx				
Accounts Receivable		xxxx			
Record payment received					

Exhibit 5-8

Note that regardless of which inventory system is used, the seller has to record the first step—the sales-related activities. Only in the perpetual inventory system does the seller need to record the second step to update the inventory activities, such as the reduction of inventory when it is sold and the increase of inventory when it is returned by the customer.

CRITICAL THINKING

Take a minute to think about the impact of the following independent cases on each of the assets, liabilities, and shareholders' equity accounts, based on each of the scenarios. Examine the impact of the cost of the inventory only.

1. Using the periodic inventory method, the sale of inventory for $7,000 (with a cost of $5,000) on account was recorded, but the cost of inventory was not recorded.
2. Using the perpetual inventory method, the sale of inventory for $8,500 (with a cost of $6,200) on account was recorded, but the cost of inventory was not recorded.
3. Using the perpetual inventory method, the purchase of inventory with a term FOB shipping point, the shipping cost of $500 on account was recorded in the Shipping Expense account.
4. Using the perpetual inventory method, a purchase discount of $250 was recorded in the Purchase Discounts account.

Solutions:

	Impact on Accounts			
	Assets	Liabilities	Shareholders' Equity	Entry in Accounting Record
1.	No	No	No	This is correct—no entry is required for the inventory update since the periodic system is used.
2.	+ 6,200	No	+ 6,200	Assets and Shareholders' Equity would be overstated because the change in inventory was not recorded. The correct entry should include: Cost of Goods Sold (Dr); Inventory (Cr) in the amount of $6,200.
3.	– 500	No	– 500	Assets and Shareholders' Equity would be understated because the cost of the shipping should have been included in the inventory account rather than in a shipping expense account. To correct the entry, the buyer should record the adjusting entry: Inventory (Dr); Shipping Expense (Cr)
4.	+ 250	No	+ 250	Assets and Shareholders' Equity would be overstated because the discount should have reduced the Inventory account instead of going into a contra account against purchases. To correct the entry, the buyer should record the adjusting entry: Purchase Discounts (Dr); Inventory (Cr)

HOW DO YOU PREPARE A MERCHANDISER'S FINANCIAL STATEMENTS?

The Income Statement

6 Prepare a multi-step income statement and a classified balance sheet

In earlier chapters, you learned how to complete the financial statements for a service business. Most service businesses use a **single-step income statement**. The single-step income statement groups all revenues together and all expenses together. Then, the total expenses are subtracted from total revenues in a single step without calculating any subtotals. The advantage of the single-step format is that it clearly distinguishes revenues from expenses. Although Cosmic Cellular is a merchandiser, **Exhibit 5-9** illustrates its income statement for the year ended December 31, 2013, prepared using the single-step format. We focus on the first part of the comprehensive income statement, Income Statement. The second part of the comprehensive income statement, Other Comprehensive Income, will be covered in higher-level accounting courses.

Cosmic Cellular, Inc.
Income Statement
Year Ended December 31, 2013

Revenues:		
Net Sales Revenue		$167,900
Expenses:		
Cost of Goods Sold	$90,300	
Selling Expenses	1,200	
General and Administrative Expenses	19,650	
Interest Expense	1,100	
Total Expenses		112,250
Net Income		$ 55,650

Exhibit 5-9

Most merchandisers use a **multi-step income statement**. The multi-step income statement is prepared in steps. Important subtotals are computed as part of the calculation of net income or net loss. Investors prefer this format because it provides step-by-step information about the profitability of the business. This format makes it more useful for managers within the business as well as investors outside of the business. The multi-step income statement for most merchandisers will contain most, but not necessarily all, of the following items:

- **Net Sales Revenue** is presented first, and is calculated by subtracting both Sales Returns and Allowances and Sales Discounts from Sales Revenue. Keep in mind that a company may not offer its customers any sales discounts. Also, even if sales discounts are offered, customers may not take advantage of them. Therefore, it is possible that no sales discounts will appear on a company's income statement.
- The cost of the merchandise that is sold appears next as Cost of Goods Sold. Remember, with the perpetual inventory method, cost of goods sold is already known as this is recorded with the sales transactions; however, if the periodic inventory method is used, then cost of goods sold needs to be calculated.

- **Gross Profit**, also called **Gross Margin**, is a subtotal computed next. The gross profit equals Net Sales Revenue minus Cost of Goods Sold.
- **Operating Expenses** are the expenses, other than cost of goods sold, of operating the business. Operating Expenses are listed after Gross Profit. Many companies report operating expenses in two categories:
  1. Selling Expenses include sales salaries, commissions, advertising, promotion, depreciation for items used in sales, and delivery costs to customers.
  2. **General and Administrative Expenses** include office expenses, such as the salaries of the company president and office employees, depreciation of items used in administration, rent, utilities, and property taxes on the office building.
- On the multi-step income statement, Gross Profit minus Operating Expenses equals **Operating Income**, or **Income from Operations**. Operating income measures the results of the entity's primary, ongoing business activities.
- The last section of a multi-step income statement is **Other Revenues and Expenses**. This category reports revenues and expenses that fall outside of a business's main operations. Examples include interest revenue, interest expense, dividend revenue, and gains and losses on the sale of long-term assets. Because not every business has revenues and expenses outside its business operations, not all income statements will include this section.
- The last line of the multi-step income statement is Net Income or Net Loss. To calculate, add Other Revenues and subtract Other Expenses from Operating Income. The final results of operations, net income or net loss, is a company's *bottom line,* a commonly used business term.

Cosmic Cellular's multi-step income statement for the year ended December 31, 2013, appears in **Exhibit 5-10** along with the statement of retained earnings and the balance sheet.

After you review Cosmic Cellular's multi-step income statement in Exhibit 5-10, look again at its single-step version in Exhibit 5-9. Notice that in both formats net income is exactly the same. The format of the income statement does not change the net income or net loss of a business. It simply changes how the calculation of net income or net loss is presented.

DECISION GUIDELINES

Decision	Guideline	Analyze
I have an appointment at the bank to request a new loan. Which format of financial statement should I use?	The choice of the format for the statement depends on who the intended users of the financial statements are.	The *single-step format* shows the calculation of net income or net loss by subtracting all expenses from all revenues in a single step. The single-step format typically shows summary information and is intended for users who do not need much detail. This format would not be a good format for creditors or investors to use but it would be great to use in a press release or newspaper article. The *multi-step format* shows the calculation of net income or net loss in a series of steps with subtotals for *gross profit* and *operating income*. This format shows detailed information and is best suited for creditors and investors.

Cosmic Cellular, Inc.
Income Statement
Year Ended December 31, 2013

Sales Revenue		$171,300	
Less: Sales Returns and Allowances		3,400	
Net Sales Revenue			$167,900
Cost of Goods Sold			90,300
Gross Profit			77,600
Operating Expenses:			
Selling Expenses:			
Advertising	$ 1,000		
Delivery Expense	200	1,200	
General and Administrative Expenses:			
Wage Expense	10,200		
Rent Expense	7,300		
Insurance Expense	1,000		
Depreciation Expense, Office Equipment	600		
Supplies Expense	550	19,650	20,850
Operating Income			56,750
Other Revenues and (Expenses):			
Interest Expense			(1,100)
Net Income			$ 55,650

Cosmic Cellular, Inc.
Statement of Retained Earnings
Year Ended December 31, 2013

Retained Earnings, December 31, 2012	$ 20,900
Add: Net Income	55,650
Subtotal	76,550
Less: Dividends	55,900
Retained Earnings, December 31, 2013	$ 20,650

Cosmic Cellular, Inc.
Classified Balance Sheet
December 31, 2013

ASSETS			**LIABILITIES**		
Current Assets:			Current Liabilities:		
Cash	$ 3,150		Accounts Payable	$30,000	
Accounts Receivable	4,600		Wages Payable	400	
Supplies	100		Unearned Sales Revenue	700	
Inventory	39,700		Total Current Liabilities		$31,100
Prepaid Insurance	200		Long-Term Liabilities		
Total Current Assets		$47,750	Mortgage Payable		10,000
Long-Term Assets:			Total Liabilities		41,100
Office Equipment	32,000				
Less: Accumulated			**SHAREHOLDERS'**		
Depreciation, Office			**EQUITY**		
Equipment	3,000	29,000	Common Shares	15,000	
			Retained Earnings	20,650	
			Total Equity		35,650
			Total Liabilities &		
Total Assets		$76,750	Shareholders' Equity		$76,750

Exhibit 5-10

The Statement of Retained Earnings

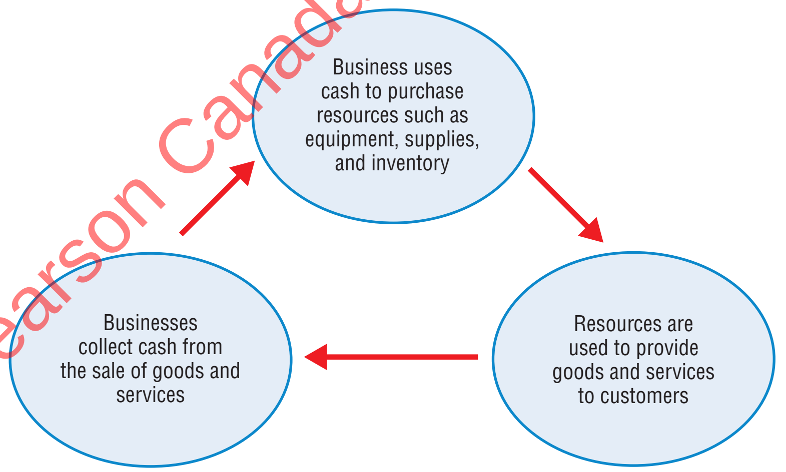
A merchandiser's statement of retained earnings, which is one component of the Statement of Equity, looks exactly like that of a service business. Cosmic's statement of retained earnings is presented in Exhibit 5-10.

The Balance Sheet

To provide more useful information, merchandisers, as well as most service businesses, usually prepare a **classified balance sheet**. A classified balance sheet lists assets in classes in the order of their **liquidity**. Liquidity refers to how close an asset is to becoming cash or being used up. Similar to the assets, the liabilities are listed in classes based on how soon the obligation will be paid or fulfilled. By listing the assets and liabilities in these classes, financial statement users can better analyze the business's ability to pay its bills on time.

Assets

The most liquid assets are presented on a classified balance sheet in a class called Current Assets. Current Assets are assets that will be converted to cash, sold, or used up during the next 12 months or within a business's normal **operating cycle** if longer than one year.



The Operating Cycle

For most businesses, the operating cycle is a few months. Cash, Accounts Receivable, Notes Receivable due within one year, and Prepaid Expenses are all current assets. If the business is a merchandiser, then the major difference between its balance sheet and that of a service business is that it also shows Inventory as a current asset.

All assets other than current assets are reported in a class called long-term assets. One category of long-term assets is called **plant assets** or **fixed assets**. This category is labelled on the balance sheet as **property, plant, and equipment**. Land, buildings, furniture, fixtures, and equipment are examples of these assets.

Liabilities

The debts or obligations of a business that must be paid for or fulfilled within one year (or within the entity's operating cycle if the cycle is longer than a year) are reported in a class called current liabilities. Accounts Payable, Notes Payable due within one year, Salary Payable, Interest Payable, and Unearned Revenue are current liabilities.

Obligations that extend beyond one year are reported as **long-term liabilities**. Often, a business owner signs a contract to repay a note or mortgage over several years. The portion of the note or mortgage that must be paid within one year is classified as a current liability. However, the remaining balance is a long-term liability.

The balance sheet for Cosmic Cellular is presented in Exhibit 5-10. Cosmic's balance sheet is presented in **account form**. The account form lists the assets on the left and the liabilities and shareholders' equity on the right, just as these accounts appear in the accounting equation. It is also acceptable to present the balance sheet in **report form**, which lists the assets at the top and the liabilities and shareholders' equity on the bottom.

FOCUS ON DECISION MAKING: RATIOS

The Gross Profit Percentage

7 Compute the gross profit percentage and the current ratio

Gross profit, also called gross margin, is a key tool in evaluating merchandising operations. Remember that gross profit is net sales revenue minus the cost of goods sold. Thus, gross profit is the amount left over from sales after deducting the cost of the merchandise sold. Merchandisers strive to maximize gross profit to help maximize net income. The **gross profit percentage**, also called the **gross margin percentage**, shows how well a merchandising business meets this goal. The gross profit percentage measures the relationship between gross profit and sales.

The gross profit percentage is one of the most carefully watched measures of profitability by investors and business managers. This information is used to compare changes in gross profit from year to year for the business. Also, it is used to compare the company to other businesses in the same industry. For most businesses, the gross profit percentage changes little from year to year. To investors, a significant change in the gross profit percentage signals a significant change in the business's operations meriting further investigation.

To compute the gross profit percentage, divide gross profit by net sales revenue. Based on information provided from the income statement in Exhibit 5-10, the gross profit percentage for Cosmic Cellular is 46.2%, calculated as follows:

$$\text{Gross Profit Percentage} = \frac{\text{Gross Profit}}{\text{Net Sales Revenue}} = \frac{\$77{,}600}{\$167{,}900} = 0.462 = 46.2\%$$

A 46.2% gross margin percentage means that each dollar of net sales generates 46.2 cents of gross profit. Every time Cosmic Cellular sells $1 of merchandise, it produces 46.2 cents of gross profit that hopefully covers operating expenses and generates net income.

The Current Ratio

The **current ratio** is one of the most widely used tools by investors, creditors, and suppliers. They use the current ratio to evaluate a company's ability to pay its obligations as they come due. The granting of credit is often based upon a company having a strong current ratio. The current ratio measures a company's ability to pay its current liabilities by comparing those liabilities to its current assets. The formula for calculating the current ratio is as follows:

$$\text{Current Ratio} = \text{Current Assets/Current Liabilities}$$

A high current ratio is desired because that means a company has plenty of current assets to pay its current liabilities. An increasing current ratio over time indicates improvement in a company's ability to pay current debts. A general benchmark is that a strong current ratio is 1.50. This indicates that the company has $1.50 in current assets for every $1.00 in current liabilities. A company with a current ratio of 1.50 would probably have little trouble paying its current liabilities. A current ratio below 1.00 is considered low.

Based on information provided from the balance sheet in Exhibit 5-10, the current ratio for Cosmic Cellular is 1.54, calculated as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$47{,}750}{\$31{,}100} = 1.54$$

It appears that Cosmic Cellular should have no trouble paying its obligations as they come due.

DECISION GUIDELINES

Decision	Guideline	Analyze
As a supplier, I am looking at a new customer's financial statements to determine whether or not to grant credit for the customer to make purchases. What can I use to to evaluate the company's performance for this decision?	Key ratios are often used as a quick way to measure a business's performance.	The *gross profit percentage* helps analyze the profitability of a merchandiser. The gross profit percentage provides a measurement of how much of each sales dollar remains after covering the cost of the goods sold. The *current ratio* can be used to determine a business's ability to pay its obligations as they come due. A current ratio that is above 1.5 is generally considered to be good. However, if a current ratio gets too high it can be an indicator that the business has too much tied up in current assets and, therefore, is not utilizing its assets as effectively as it could be.

FOCUS ON USERS

Concept	User	Why is this Important to this User?
Perpetual and Periodic Inventory		Management needs to know whether the inventory amounts that are showing in the general ledger are reliable for decision making. If the company uses a perpetual system, then the inventory account is continually updated and will only be missing any details for inventory that has disappeared but not been sold (stolen, damaged, etc.). If the company uses a periodic system, then a visual inspection or manual count of the inventory would be needed to know the amount in inventory.
Free On Board (FOB)		It is important to management to understand what is included in the ending inventory amounts so that management can plan for inventory purchases in the next month. For any purchases that have been sold and are in the process of being delivered, the FOB details need to be known to understand if these items are included in the ending inventory account. If the items were sold FOB destination, then the ending inventory amounts will still include these items even though they have been sold.
		Similar to managers, creditors need to understand the composition of the ending inventory, but creditors would want to know this information because the inventory may be used as collateral for loans.
Multi-Step Income Statement		Shareholders and potential investors will closely examine a multi-step income statement for details on gross profit. Gross profit shows how much the company has to contribute to expenses after the cost of the inventory sold is deducted. The gross profit percentage would be compared to other companies in the same industry, which can help determine the strategy of the company as either a high-volume low-price strategy (such as a dollar store or discount retailer) or as a low-volume high-price strategy (such as a high-quality brand retailer).
		Creditors would be interested in the operating income amount on a multi-step income statement as this gives an indication of how effectively the company operates its normal operations. For example, a pizza company that also has a warehouse that it rents to other companies would show how much it has earned in income from just making and selling pizzas in the operating income.

DEMO DOC

MyAccountingLab

Visit MyAccountingLab at www.myaccountinglab.com to watch animated versions of these Demo Docs.

L.O. 3 – 5

Transaction Analysis for a Merchandiser Using the Perpetual Inventory System

Spokane Paper Products, Inc. had the following transactions in March 2013:

Mar	1	Purchased $1,500 of inventory on account. Terms were 2/10, n/30, FOB destination.
	2	Sold inventory for cash, $800 (cost, $550).
	7	Returned $400 of the inventory purchased on March 1 because it was defective.
	9	Paid supplier for goods purchased on March 1.
	11	Purchased inventory for $1,800 on account. Terms were 3/15, n/30, FOB shipping point.
	14	Paid freight bill on merchandise purchased on March 11, $125.
	18	Sold inventory for $2,200 (cost, $1,500) on account. Terms were 2/10, n/30, FOB shipping point.
	24	Paid supplier for goods purchased on March 11.
	26	The customer from the March 18 sale returned $750 ($500 cost) of goods.
	28	Received cash in full settlement of its account from the customer who purchased inventory on March 18.

Requirement:

1 **Journalize these transactions by using the perpetual inventory system. Omit explanations.**

Demo Doc Solution

Requirement 1

Journalize these transactions. Omit explanations.

Part 1	Demo Doc Complete

Mar 1 Purchased $1,500 of inventory on account. Terms were 2/10, n/30, FOB destination.

The purchase of inventory causes the Inventory account to increase by $1,500. The Inventory account is an asset and is, therefore, increased with a debit. Because the purchase was made on account, Accounts Payable is increased (credited) by $1,500. The credit terms are not relevant until the *payment* is made to the supplier. The freight terms indicate that the supplier is responsible for paying the freight charges.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 1	Inventory		1,500	
	Accounts Payable			1,500

Mar 2 Sold inventory for cash, $800 (cost, $550).

Under the perpetual inventory method, the entry required to account for a sale requires two parts. The first part of the entry is required to record the recognition of revenue. Because the sale was a cash sale, the Cash account is increased (debited) by $800. When merchandise is sold (and delivered) to a customer, the company earns sales revenue. By selling merchandise, Spokane

Paper Products, Inc. has earned sales revenue of $800. Therefore, Sales Revenue is increased (credited) by $800.

The second part of the entry is required to record the cost of the goods sold. The Cost of Goods Sold account is increased (debited) for $550 (Spokane Paper Products' cost of the merchandise). Remember, Cost of Goods Sold is an *expense*. Because goods from inventory were given to the customer, the Inventory account is decreased (credited) by $550.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 2	Cash		800	
	Sales Revenue			800
	Cost of Goods Sold		550	
	Inventory			550

Mar 7 Returned $400 of the inventory purchased on March 1 because it was defective.

Because Spokane Paper Products, Inc. has not yet paid for the purchase, the return of the merchandise will result in a $400 decrease (debit) to Accounts Payable. Also, because the goods were returned to the supplier, the Inventory account will be decreased (credited) by $400.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 7	Accounts Payable		400	
	Inventory			400

Mar 9 Paid supplier for goods purchased on March 1.

Because the original purchase was made on account, we need to consider the credit terms, which were 2/10, n/30. Because Spokane Paper Products, Inc. is paying within the 10-day discount period, it is entitled to take a 2% discount. However, the discount does not apply to the $400 of goods that Spokane Paper Products, Inc. has returned. It only applies to the net account payable that Spokane Paper Products, Inc. owes after the return.

Original purchase price of goods	$1,500
Less amount of goods returned	$ 400
Net account payable	$1,100

The discount, and the amount of cash paid, is calculated as follows:

Net account payable	$ 1,100
Less 2% discount	$ (22) (2% × $1,100)
Total cash paid	$ 1,078

Accounts Payable is decreased (debited) by the remaining amount due of $1,100. The cash account will be decreased (credited) by the $1,078 of cash paid. The $22 difference is the discount and is treated as a reduction to the Inventory account because it represents a reduction in the cost of the inventory. So, Inventory is decreased (credited) by the $22 amount of the discount.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 9	Accounts Payable		1,100	
	Cash			1,078
	Inventory			22

Mar 11 Purchased inventory for $1,800 on account. Terms were 3/15, n/30, FOB shipping point.

The purchase of inventory causes the Inventory account to increase (debit) by $1,800. Because the purchase was made on account, Accounts Payable is increased by $1,800 with a credit. The credit terms are not relevant until the *payment* is made to the supplier. The freight terms indicate that the Spokane Paper Products, Inc. is responsible for paying the freight charges.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 11	Inventory		1,800	
	Accounts Payable			1,800

Mar 14 Paid freight bill on merchandise purchased on March 11, $125.

The shipping terms of FOB shipping point means that Spokane Paper Products, Inc. is responsible for paying the freight charges. Because the freight charges represent an increase in the cost of the inventory to Spokane Paper Products, the Inventory account will be increased (debited) by $125. Cash will be decreased (credited) by $125.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 14	Inventory		125	
	Cash			125

Mar 18 Sold inventory for $2,200 (cost, $1,500) on account. Terms were 2/10, n/30, FOB shipping point.

Remember, under the perpetual inventory method, the entry required to account for a sale requires two parts. The first part of the entry is required to record the recognition of revenue. Because the sale was on account, the Accounts Receivable account is increased (debited) by $2,200. Sales revenue is increased (credited) by $2,200. The second part of the entry is required to record the cost of the goods sold. The Cost of Goods Sold account is increased (debited) for $1,500 and Inventory is decreased (credited) by $1,500.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 18	Accounts Receivable		2,200	
	Sales Revenue			2,200
	Cost of Goods Sold		1,500	
	Inventory			1,500

Mar 24 Paid supplier for goods purchased on March 11.

Because the original purchase was made on account, we need to consider the credit terms, which were 3/15, n/30. Because Spokane Paper Products, Inc. is paying within the 15-day discount period, it is entitled to take a 3% discount. There were no returns related to this purchase so the discount, and the amount of cash paid, is calculated as follows:

Net account payable	$ 1,800
Less 3% discount (3% × $1,800)	$ (54)
Total cash paid	$ 1,746

Accounts Payable is decreased (debited) by the amount due of $1,800. The Cash account will be decreased (credited) by the $1,746 of cash paid. The $54 difference is the discount and is treated as a reduction to the Inventory account because it represents a reduction in the cost of the inventory. So, Inventory is decreased (credited) by the $54 amount of the discount.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 24	Accounts Payable		1,800	
	Cash			1,746
	Inventory			54

Mar 26 The customer from the March 18 sale returned $750 ($500 cost) of goods.

Just as the sale of goods under the perpetual inventory method requires a two-part entry, so does the return of goods from a customer. The first part of the entry "undoes" the sale and is recorded by increasing (debiting) the contra-account Sales Returns and Allowances by $750. The customer has not yet paid the account, so the return of the goods will result in a decrease (credit) to Accounts Receivable for $750. The second part of the entry will record the physical return of the goods. The Inventory account is increased (debited) by $500, the value of the goods returned and put back for resale. Because the goods were returned and were put back for resale, they are no longer "sold," so the Cost of Goods Sold account is decreased (credited) by $500.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 26	Sales Returns and Allowances		750	
	Accounts Receivable			750
	Inventory		500	
	Cost of Goods Sold			500

Mar 28 Received cash in full settlement of its account from the customer who purchased inventory on March 18.

Because the original purchase was made on account, we need to consider the credit terms, which were 2/10, n/30. Because the customer is paying within the 10-day discount period, he or she is entitled to take a 2% discount. However, the discount does not apply to the $750 of goods that the customer returned. It only applies to the net account receivable that the customer still owes to Spokane Paper Products, Inc. after the return.

Original sales price of goods	$2,200
Less amount of goods returned	$ 750
Net account receivable	$1,450

The discount, and the amount of cash Spokane Paper Products, Inc. receives, is calculated as follows:

Net account receivable	$ 1,450
Less 2% discount (2% × $1,450)	$ (29)
Total cash received	$ 1,421

The cash account will be increased (debited) by the $1,421 of cash received. The amount of the discount, $29, is recorded as an increase (debit) to the contra-account, Sales Discounts. Accounts Receivable is decreased (credited) by the net account receivable of $1,450.

DATE	ACCOUNTS	POST REF.	DR.	CR.
Mar 28	Cash		1,421	
	Sales Discounts		29	
	Accounts Receivable			1,450

Demo Doc Complete

Part 1	Demo Doc Complete

DECISION GUIDELINES

Accounting for a Merchandising Business

As a merchandiser, you might be faced with decisions such as the following:

Decision	Guideline	Analyze
Which inventory system should my business use?	This decision depends on whether or not you plan on utilizing a computer system to help with inventory management.	The *perpetual system* shows the current, correct amounts of inventory on hand and the cost of goods sold at all times. The *periodic system* requires that a physical count of the inventory be taken to know the correct balances of inventory and cost of goods sold. Before computers, only businesses that sold smaller quantities of higher cost items could use the perpetual method. Today, thanks to computers and other technology, most companies utilize the perpetual method even if they sell a high quantity of low cost items.
I have an appointment at the bank to request a new loan. Which format of financial statement should I use?	The choice of the format for the statement depends on the intended users of the financial statements.	The *single-step format* shows the calculation of net income or net loss by subtracting all expenses from all revenues in a single step. The single-step format typically shows summary information and is intended for users who do not need much detail. This format would not be a good format for creditors or investors to use but it would be great to use in a press release or newspaper article. The *multi-step format* shows the calculation of net income or net loss in a series of steps with subtotals for *gross profit* and *operating income*. This format shows detailed information and is best suited for creditors and investors.
As a supplier, I am looking at a new customer's financial statements to determine whether or not to grant credit for the customer to make purchases. What can I use to to evaluate the company's performance for this decision?	Key ratios are often used as a quick way to measure a business's performance.	The *gross profit percentage* helps analyze the profitability of a merchandiser. The gross profit percentage provides a measurement of how much of each sales dollar remains after covering the cost of the inventory. The *current ratio* can be used to determine a business's ability to pay its obligations as they come due. A current ratio that is above 1.5 is generally considered to be good. However, if a current ratio gets too high it can be an indicator that the business has too much tied up in current assets and, therefore, is not utilizing its assets as effectively as it could be.

ACCOUNTING VOCABULARY

THE LANGUAGE OF BUSINESS

Account form (p. 299) A balance sheet format that lists assets on the left of the report and liabilities and shareholders' equity on the right, just as those accounts appear in the accounting equation.

Classified balance sheet (p. 298) A balance sheet that separates assets and liabilities into current and long-term classes.

Cost of Goods Sold (p. 283) The cost of the inventory that the business has sold to customers.

Credit memorandum (p. 285) A document that supports the return of goods from the customer and the adjustment to the customer's account balance.

Credit terms (p. 279) The payment terms for customers who buy on account.

Current ratio (p. 299) The ratio of current assets to current liabilities; a key measure of liquidity.

Debit memorandum (p. 279) A document that supports the return of goods to the supplier and the adjustment to the balance owed to the supplier.

Discount period (p. 280) Period in which the buyer can make early payment for a purchase and receive a discount on that purchase.

eom (p. 279) Credit term specifying that payment for a purchase is due by the end of the month; also referred to as *n/eom*.

Fixed assets (p. 298) The long-lived assets of a business including land, buildings, furniture, fixtures, and equipment; also called *plant assets* and commonly shown on the balance sheet as property, plant, and equipment.

Free on board (FOB) destination (p. 288) A shipping term specifying that title to goods passes to the buyer when the goods are received at the buyer's destination; thus, the seller pays the cost of shipping the goods to this destination.

Free on board (FOB) shipping point (p. 288) A shipping term specifying that title to goods passes to the buyer when the goods are shipped at the seller's place of business; thus, the buyer pays the cost of shipping the goods to its location.

Freight charges (p. 288) The cost of shipping merchandise from the seller to the buyer.

General and Administrative Expenses (p. 296) Office expenses, such as the salaries of the company president and office employees, depreciation of items used in administration, rent, utilities, and property taxes on the office building.

Gross Margin (p. 296) Net sales revenue minus cost of goods sold; also called *gross profit*.

Gross margin percentage (p. 299) A measure of profitability equal to gross margin divided by net sales revenue; also called *gross profit percentage*.

Gross Profit (p. 296) Net sales revenue minus cost of goods sold; also called *gross margin*.

Gross profit percentage (p. 299) A measure of profitability equal to gross profit divided by net sales revenue; also called *gross margin percentage*.

Income from Operations (p. 296) Gross profit minus operating expenses; also called *operating income*.

Inventory (p. 276) Goods purchased for resale to customers in the normal course of merchandising operations; also called *merchandise inventory*.

Liquidity (p. 298) The ability to convert an asset to cash quickly.

Long-term liabilities (p. 299) Liabilities other than those that are current.

Merchandise inventory (p. 276) Goods purchased for resale to customers in the normal course of merchandising operations; also called *inventory*.

Multi-step income statement (p. 295) Income statement format that calculates net income or net loss by listing important subtotals, such as gross profit and operating income.

n/30 (p. 279) Credit term specifying that payment for a purchase is due within 30 days after the date of the invoice.

n/eom (p. 279) Credit term specifying that payment for a purchase is due by the end of the month; also referred to as *eom*.

Net Sales Revenue (p. 295) Sales revenue less sales discounts and sales returns and allowances.

Operating cycle (p. 298) The time span during which the business obtains resources, uses them to sell goods and services to customers, and collects cash from these customers.

Operating expenses (p. 296) Expenses of operating a business other than cost of goods sold. Examples include depreciation, rent, salaries, utilities, advertising, delivery expense, property taxes, and supplies expense.

Operating Income (p. 296) Gross profit minus operating expenses. Also called *income from operations*.

Other Revenues and Expenses (p. 296) Revenues and expenses that fall outside the main operations of a business, such as interest expense and a loss on the sale of long-term assets.

Periodic inventory system (p. 276) An inventory system in which the business does not keep a continuous record of inventory on hand. At the end of the period, a physical count of inventory is taken and determines the inventory owned as well as the cost of the goods sold.

Perpetual inventory system (p. 277) An inventory system in which the business keeps a continuous record of inventory on hand and the cost of the goods sold.

Plant assets (p. 298) The long-lived assets of a business including land, buildings, furniture, fixtures, and equipment; also called *fixed assets* and commonly shown on the balance sheet as property, plant, and equipment.

Property, plant, and equipment (p. 298) A heading often seen on the balance sheet used to describe fixed, or plant, assets.

Purchase discount (p. 277) Discount received on purchases by paying early within a discount period.

Purchase returns and allowances (p. 277) A reduction in the amount owed for a purchase due to returning merchandise or accepting damaged goods.

Report form (p. 299) A balance sheet format that reports assets at the top of the report, followed by liabilities, and ending with shareholders' equity at the end of the report.

Retailers (p. 276) Businesses that buy goods from manufacturers or wholesalers and resell them to the general public.

Sales Discount (p. 286) Discount granted on sales for the customer's early payment within a discount period; a contra-account to Sales Revenue.

Sales invoice (p. 279) A bill that documents the sale of goods to a business customer.

Sales Returns and Allowances (p. 285) A reduction in the amount of sales due to customers returning merchandise or accepting damaged goods; a contra-account to Sales Revenue.

Sales revenue (p. 283) The amount that a retailer earns from selling its inventory.

Selling expenses (p. 292) Expenses related to advertising and selling products including sales salaries, sales commissions, advertising, depreciation on items used in sales, and delivery expense.

Single-step income statement (p. 295) Income statement format that groups all revenues together and lists all expenses together, subtracting total expenses from total revenues and calculating net income or net loss without computing any subtotals.

Subsidiary ledger (p. 278) An accounting record that contains details, such as a list of customers and the accounts receivable due from each, or a list of suppliers and the accounts payable due to each.

Title (p. 288) Ownership.

ACCOUNTING PRACTICE

DISCUSSION QUESTIONS

1. What accounts will appear on the financial statements of a merchandiser that will not appear on those of a service-oriented company?
2. What are some reasons why a merchandiser might prefer to use a perpetual inventory system over a periodic inventory system?
3. Why do businesses use subsidiary ledgers?
4. What do the terms 2/10, n/30 mean? If you were advising a company who bought goods under these terms, what would you advise it to do with respect to payment? Why?
5. How many accounts are involved in recording the sale of merchandise on credit?
6. What kind of account is Sales Returns and Allowances? Where would it appear on the financial statements?
7. What is a debit memorandum? What is a credit memorandum? Give an example of the types of transactions for which each would be used.
8. What does the term "free on board" mean? Why is this an important term to understand if you are involved in making decisions about the purchasing of inventory or the setting of prices for your products?
9. What is the difference between a single-step and multi-step income statement? For what type of business is a multi-step income statement most appropriate?

10. What situation might explain why a company's gross profit percentage went down from 60% to 40% from one year to the next?

SELF CHECK

1. Which account does a merchandiser use that a service company does not use?

a. Cost of goods sold
b. Inventory
c. Sales revenue
d. All of the above

2. The two main inventory accounting systems are the

a. perpetual and periodic.
b. purchase and sale.
c. returns and allowances.
d. cash and accrual.

3. Which of the following journal entries for the purchase of $900 of inventory on account, using the perpetual inventory system, is correct?

DATE	ACCOUNTS	POST REF.	DR.	CR.
a.	Cost of Goods Sold		900	
	Accounts Payable			900
b.	Inventory		900	
	Accounts Payable			900
c.	Accounts Payable		900	
	Inventory			900
d.	Inventory		900	
	Cash			900

4. Apex Electrical Supply, Inc. purchased inventory for $2,000 and also paid $125 freight to have the inventory delivered. Apex Electrical Supply, Inc. returned $500 of the goods to the seller and later took a 2% purchase discount. What is the final cost of the inventory that Apex Electrical Supply, Inc. kept?

a. $2,083
b. $2,085
c. $1,595
d. $1,593

5. Suppose Bonzai Boards, Inc. had sales of $180,000 and sales returns of $22,000. Cost of goods sold was $110,000. How much gross profit did Bonzai Boards, Inc. report?

a. $48,000
b. $70,000
c. $92,000
d. $158,000

6. Suppose Apex Electrical Supply's Inventory account showed a balance of $43,000. A physical count showed $41,800 of goods on hand. To adjust the inventory account, Apex Electrical Supply, Inc. would make which of the following entries:

DATE	ACCOUNTS	POST REF.	DR.	CR.
a.	Cost of Goods Sold		1,200	
	Inventory			1,200
b.	Accounts Payable		1,200	
	Inventory			1,200
c.	Inventory		1,200	
	Cost of Goods Sold			1,200
d.	Inventory		1,200	
	Accounts Payable			1,200

7. If Bonzai Boards, Inc. returned $3,600 of snowboards to a supplier it would record the transaction as which of the following?

DATE	ACCOUNTS	POST REF.	DR.	CR.
a.	Cost of Goods Sold		3,600	
	Inventory			3,600
b.	Accounts Payable		3,600	
	Sales Returns and Allowances			3,600
c.	Inventory		3,600	
	Accounts Payable			3,600
d.	Accounts Payable		3,600	
	Inventory			3,600

8. An asset is classified as current if it

a. was purchased within the last six months.
b. will become cash, be sold, or be used up within 12 months.
c. was purchased with cash.
d. will last longer than one year.

9. The income statement format that shows important subtotals is referred to as

a. a classified income statement.
b. a single-step income statement.
c. a multi-step income statement.
d. a subtotalled income statement.

10. Suppose Bonzai Boards, Inc. had sales of $210,000 and sales returns of $18,000. Cost of goods sold was $125,000. What was Bonzai Boards' gross profit percentage (rounded) for this period?

a. 35%
b. 54%
c. 40%
d. 32%

Answers are given after Written Communication.

SHORT EXERCISES

S5-1. Inventory methods (*Learning Objective 2*) 5–10 min.

The following characteristics are related to either periodic inventory or perpetual inventory systems.

a. A physical count of goods on hand at year end is required.

b. Inventory records are continuously updated.

c. Purchases of inventory are recorded in an asset account at the time of purchase.

d. Bar code scanners are often utilized when using this inventory system.

e. It is necessary to calculate the cost of goods sold at the end of the year with this inventory system.

Identify each characteristic as one of the following:

a. Periodic inventory.

b. Perpetual inventory.

c. Both periodic and perpetual inventory.

d. Neither periodic nor perpetual inventory.

S5-2. Adjusting inventory based on a physical count (*Learning Objective 2*) 5–10 min.

Charleston's Furniture uses the perpetual inventory method. At the end of the year, Charleston's Furniture's Inventory account had a ledger balance of $87,000. A physical inventory count revealed that the actual inventory on hand totaled $85,300.

Journalize the transaction necessary to adjust the Inventory account at the end of the year.

S5-3. Journalizing inventory purchases (*Learning Objective 3*) 5–10 min.

Suppose Sports-R-Us purchases $40,000 of sportswear on account from Pacific Trail on March 1, 2013. Credit terms are 2/10, net 30. Sports-R-Us pays Pacific Trail on March 8, 2013.

1. Journalize the transactions for Sports-R-Us on March 1, 2013, and March 8, 2013, using (1) the perpetual system and (2) the periodic inventory system.

2. What was the final cost of this inventory for Sports-R-Us?

S5-4. Inventory purchases and returns (*Learning Objective 3*) 5–10 min.

Sonny's Spas, Inc. purchased $8,000 worth of inventory from the Pool Warehouse on account, terms of 2/10, n/30. Some of the goods are damaged in shipment, so Sonny's Spas, Inc. returns $1,100 of the merchandise to the Pool Warehouse.

How much must Sonny's Spas, Inc. pay the Pool Warehouse

1. after the discount period?

2. within the discount period?

S5-5. Journalizing inventory purchases and returns (*Learning Objective 3*) 5–10 min.

Sonny's Spas, Inc. purchased $8,000 worth of inventory from the Pool Warehouse on account, terms of 2/10, n/30. Some of the goods are damaged in shipment, so Sonny's Spas, Inc. returns $1,100 of the merchandise to the Pool Warehouse.

Journalize the following transactions, using (1) the perpetual system and (2) the periodic inventory system, for Sonny's Spas, Inc. Explanations are not required.

a. Purchase of the goods

b. Return of the damaged goods

c. Payment for the goods within the discount period

S5-6. Journalizing inventory purchases and freight charges (*Learning Objectives 3 & 5*) 5–10 min.

Journalize the following transactions, using (1) the perpetual system and (2) the periodic inventory system, for the Jazz Man music store.

a. Purchased $8,700 of merchandise on account, terms 2/10, n/30, FOB shipping point.

b. Paid $175 to the freight company for the delivery of the merchandise purchased.

c. Paid for the inventory purchased in Part a within the discount period.

S5-7. Journalizing sales transactions (*Learning Objective 4*) 5–10 min.

Journalize the following transactions for the Pool Warehouse. Explanations are not required.

a. The Pool Warehouse sold $55,000 of merchandise to Sonny's Spas, Inc. on account, terms 2/15, n/30. The merchandise cost the Pool Warehouse $30,250.

b. Received payment for the goods from Sonny's Spas, Inc. within the discount period.

S5-8. Journalizing sales and return transactions (*Learning Objective 4*) 5–10 min.

Suppose Peter's Hardware sells merchandise on account, terms 2/10, n/45, for $750 (cost of the inventory is $460) on May 17, 2013. Peter's Hardware later received $225 of goods (cost, $140) as sales returns on May 21, 2013. The customer paid the balance due on May 26, 2013.

Journalize the May, 2013 transactions, using (1) the perpetual system and (2) the periodic inventory system, for Peter's Hardware.

S5-9. Calculate income statement items (*Learning Objective 6*) 5–10 min.

Suppose Peter's Hardware sells merchandise on account, terms 2/10, n/45, for $750 (cost of the inventory is $460) on May 17, 2013. Peter's Hardware later received $225 of goods (cost, $140) as sales returns on May 21, 2013. The customer paid the balance due on May 26, 2013.

1. Calculate net sales revenue for May 2013.

2. Calculate gross profit for May 2013.

3. Calculate the effective interest rate for the saving, if Peter's Hardware makes the payment within the discount period.

S5-10. Calculate classified balance sheet amounts (*Learning Objective 6*) 5–10 min.

Selected account balances for Jill's Java at the end of the month are listed below in random order:

Accounts Payable	$19,500
Unearned Revenue	2,000
Equipment	33,000
Inventory	37,000
Accounts Receivable	6,000
Wages Payable	1,500
Note Payable, Long-Term	28,000
Accumulated Depreciation, Equipment	4,500
Common Shares	25,000
Supplies	3,400
Building	87,000
Cash	5,200
Accumulated Depreciation, Building	24,000
Prepaid Rent	6,200
Retained Earnings	15,000

Identify or compute the following amounts for Jill's Java:

a. Total current assets

b. Total current liabilities

c. Book value of plant assets

d. Total long-term liabilities

S5-11. Prepare a multi-step income statement (*Learning Objective 6*) 10–15 min.

The accounting records for ADR, Inc. reflected the following amounts at the end of August 2013:

Cash	$3,500	Cost of Goods Sold	$19,500
Total Operating Expenses	3,700	Equipment, Net	6,100
Accounts Payable	4,500	Accrued Liabilities	1,900
Total Shareholders' Equity	5,200	Net Sales Revenue	28,000
Long-Term Notes Payable	2,300	Accounts Receivable	2,900
Inventory	1,700	Prepaid Rent	800
Wages Payable	1,100		

Prepare ADR's multi-step income statement for the fiscal year ended August 31, 2013.

S5-12. Prepare a classified balance sheet (*Learning Objective 6*) 10–15 min.

The accounting records for ADR, Inc. reflected the following amounts at the end of August 2013:

Cash	$3,500	Cost of Goods Sold	$19,500
Total Operating Expenses	3,700	Equipment, Net	6,100
Accounts Payable	4,500	Accrued Liabilities	1,900
Total Shareholders' Equity	5,200	Net Sales Revenue	28,000
Long-Term Notes Payable	2,300	Accounts Receivable	2,900
Inventory	1,700	Prepaid Rent	800
Wages Payable	1,100		

Prepare the ADR, Inc. classified balance sheet at August 31, 2013. Use the report format.

S5-13. Calculate gross profit and current ratio (*Learning Objective 7*) 10–15 min.

The accounting records for ADR, Inc. reflected the following amounts at the end of August, 2013:

Cash	$3,500	Cost of Goods Sold	$19,500
Total Operating Expenses	3,700	Equipment, Net	6,100
Accounts Payable	4,500	Accrued Liabilities	1,900
Total Shareholders' Equity	5,200	Net Sales Revenue	28,000
Long-Term Notes Payable	2,300	Accounts Receivable	2,900
Inventory	1,700	Prepaid Rent	800
Wages Payable	1,100		

Calculate the gross profit percentage and current ratio for 2013.

EXERCISES (GROUP A)

E5-1A. Adjusting inventory based on a physical count (*Learning Objective 2*) 5–10 min.

The Inventory account for McCormack Tire Company had a balance of $112,600 at the end of its fiscal year. A physical count taken at year end revealed that the value of inventory on hand amounted to $110,800.

Requirements

1. Journalize the adjustment for inventory shrinkage.
2. What could cause the inventory balance according to the physical count to be different from the ledger balance?

E5-2A. Journalizing inventory purchases, returns, and freight transactions (*Learning Objectives 3 & 5*) 10–15 min.

On June 15, 2013, Bailey's Department Store purchased $4,300 of inventory on account from one of its suppliers. The terms were 3/15, n/45, FOB shipping point. On June 18 Bailey's Department Store paid freight charges of $350 related to the delivery of the goods purchased on June 15. Upon receiving the goods, Bailey's Department Store checked the order and found $900 of unsuitable merchandise, which was returned to the supplier on June 20. Then, on June 28, Bailey's Department Store paid the invoice.

Requirement

1. Journalize all necessary transactions for Bailey's Department Store, using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

E5-3A. Journalizing inventory purchases, returns, and freight transactions (*Learning Objective 3 & 5*) 10–15 min.

Journalize the following transactions for Amazing Audio, Inc. that occurred during the month of March, using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

Mar	3	Purchased $4,600 of merchandise on account, terms 2/10, n/30, FOB shipping point. The supplier prepaid freight charges of $250 and added the amount to the invoice.
	6	Returned damaged goods to the supplier and received a credit memorandum in the amount of $600.
	12	Paid for the goods purchased on March 3.

E5-4A. Journalizing inventory sales, returns, and freight transactions (*Learning Objectives 4 & 5*) 10–15 min.

On September 14, 2013, C & T Machinery, Inc. sold $2,300 of inventory (cost is $1,350) on account to one of its customers. The terms were 1/10, n/30, FOB destination. On September 16, C & T Machinery, Inc. paid freight charges of $75 related to the delivery of the goods sold on September 14. On September 20, $900 of damaged goods (cost is $540) were returned by the customer. On September 23, C & T Machinery, Inc. received payment in full from the customer.

Requirement

1. Journalize all necessary transactions for C & T Machinery, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

E5-5A. Journalizing inventory sales, returns, and freight transactions (*Learning Objectives 4 & 5*) 10–15 min.

Journalize the following transactions for Amazing Audio, Inc. that occurred during the month of November using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations. Amazing Audio's cost of inventory is 65% of the sales price.

Nov	3	Sold $1,600 of merchandise on account, terms 2/15, n/45, FOB shipping point. Amazing Audio, Inc. prepaid $85 of shipping costs and added the amount to the customer's invoice.
	7	Issued a credit memo to the customer acknowledging the return of $250 of damaged goods.
	16	Received payment in full from the customer for the November 3 invoice.

E5-6A. Journalizing inventory purchases, sales, returns, and freight transactions (*Learning Objectives 3, 4, & 5*) 15–20 min.

The following transactions occurred during April 2013 for Angelo's Garden Centre, Inc.:

Apr	3	Purchased $3,500 of goods on account, terms 2/10, n/30, FOB shipping point.
	6	Returned $400 of defective merchandise purchased on April 3.
	8	Paid freight charges of $110 for delivery of goods purchased on April 3.
	11	Sold $4,300 of inventory to a customer on account, terms 3/15, n/45, FOB shipping point. The cost of the goods was $2,100.
	12	Paid amount owed on the April 3 purchase.
	18	Granted a $300 sales allowance on the April 11 sale because the goods were the wrong colour.
	25	Received payment in full from customer for the April 11 sale.

Requirement

1. Journalize all necessary transactions for Angelo's Garden Centre, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

E5-7A. Calculate multi-step income statement items (*Learning Objective 6*) 10–15 min.

Consider the following incomplete table of a merchandiser's profit data:

Sales	Sales Discounts	Net Sales	Cost of Goods Sold	Gross Profit
$ (a)	$2,500	$ (b)	$68,300	$32,100
64,000	1,700	(c)	44,600	(d)
102,000	(e)	93,500	(f)	28,600
(g)	2,100	86,300	57,700	(h)

Requirement

1. Complete the table by computing the missing amounts.

E5-8A. Prepare a single-step income statement (*Learning Objective 6*) 10–15 min.

The account balances for Atlantis Aquatics, Inc. for the year ended December 31, 2013, are presented next in random order:

Cash	$ 3,700	Cost of Goods Sold	$136,400
Equipment	13,700	Accumulated Depreciation, Equipment	6,100
Accounts Payable	4,500	Unearned Revenues	1,900
Common Shares	35,000	Sales Revenue	243,500
Long-Term Notes Payable	10,000	Accounts Receivable	3,200
General Expenses	18,200	Accumulated Depreciation, Building	18,500
Wages Payable	1,100	Mortgage Payable (Long-Term)	37,000
Supplies	900	Dividends	34,000
Building	125,000	Sales Discounts	2,200
Sales Returns and Allowances	4,800	Selling Expenses	26,800
Prepaid Rent	800		
Retained Earnings	13,800		
Inventory	1,700		

Requirements

Quick solution:

1. Net Income = $55,100.

1. Prepare Atlantis Aquatics' *single-step* income statement.
2. Would you recommend the use of the single-step income statement format by a merchandiser? Why?

E5-9A. Prepare a multi-step income statement; calculate gross profit percentage (*Learning Objectives 6 & 7*) 15–20 min.

Use the data for Atlantis Aquatics, Inc. from E5-8A.

Requirements

1. Prepare Atlantis Aquatics' *multi-step* income statement.
2. Calculate the gross profit percentage.
3. The gross profit percentage for 2012 was 38.7%. Did the gross profit percentage improve or deteriorate during 2013?

E5-10A. Prepare a classified balance sheet; calculate current ratio (*Learning Objectives 6 & 7*) 15–20 min.

Use the data for Atlantis Aquatics, Inc. from E5-8A.

Requirements

1. Prepare Atlantis Aquatics' classified balance sheet. Use the account format. The balance shown for retained earnings represents the balance prior to closing the temporary accounts for the year.
2. Calculate the current ratio.
3. The current ratio for 2012 was 1.25. Did the current ratio improve or deteriorate during 2013?

E5-11A. Calculate gross profit percentage and current ratio (*Learning Objective 7*) 10–15 min.

Apex, Inc. had sales revenue of $47 million, sales returns and allowances of $2 million, and sales discounts of $0.5 million in 2013. Cost of goods sold was $24 million, and net income was $7 million for the year. At December 31, the company had total assets of $36 million, of which total current assets amounted to $15 million. Apex's current liabilities were $9 million and its long-term liabilities were $4 million.

Requirement

1. Compute Apex's gross profit percentage and current ratio for 2013.

EXERCISES (GROUP B)

E5-1B. Adjusting inventory based on a physical count (*Learning Objective 2*) 5–10 min.

The Inventory account for Brady Company had a balance of $137,900 at the end of its fiscal year. A physical count taken at year end revealed that the value of inventory on hand amounted to $136,400.

Requirements

1. Journalize the adjustment for inventory shrinkage.
2. What could cause the inventory balance according to the physical count to be different from the ledger balance?

E5-2B. Journalizing inventory purchases, returns, and freight transactions (*Learning Objectives 3 & 5*) 10–15 min.

On November 15, 2013, Chandler's Department Store purchased $5,100 of inventory on account from one of its suppliers. The terms were 3/15, n/45, FOB shipping point. On November 18 Chandler's Department Store paid freight charges of $175 related to the delivery of the goods purchased on November 15. Upon receiving the goods, Chandler's Department Store checked the order and found $600 of unsuitable merchandise, which was returned to the supplier on November 20. Then, on November 28, Chandler's Department Store paid the invoice.

Requirement

1. Journalize all necessary transactions for Chandler's Department Store, using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

E5-3B. Journalizing inventory purchases, returns, and freight transactions (*Learning Objectives 3 & 5*) 10–15 min.

Journalize the following transactions for Antique Furniture, Inc. that occurred during the month of January. Omit explanations using (1) the perpetual inventory system, and (2) the periodic inventory system.

Jan	3	Purchased $5,700 of merchandise on account, terms 1/10, n/30, FOB shipping point. The supplier prepaid freight charges of $225 and added the amount to the invoice.
	6	Returned damaged goods to the supplier and received a credit memorandum in the amount of $500.
	12	Paid for the goods purchased on January 3.

E5-4B. Journalizing inventory sales, returns, and freight transactions (*Learning Objectives 4 & 5*) 10–15 min.

On November 14, 2013, Amazing Sound, Inc. sold $3,100 of inventory (cost is $1,330) on account to one of its customers. The terms were 3/10, n/30, FOB destination. On November 16, Amazing Sound, Inc. paid freight charges of $65 related to the delivery of the goods sold on November 14. On November 20, $800 of damaged goods (cost is $420) were returned by the customer. On November 23, Amazing Sound, Inc. received payment in full from the customer.

Requirement

1. Journalize all necessary transactions for Amazing Sound, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

E5-5B. Journalizing inventory sales, returns, and freight transactions (*Learning Objectives 4 & 5*) 10–15 min.

Journalize the following transactions for Antique Furniture, Inc. that occurred during the month of April using (1) the perpetual inventory system, and (2) the periodic inventory system. Antique Furniture's cost of inventory is 70% of the sales price.

Apr	3	Sold $2,100 of merchandise on account, terms 1/15, n/45, FOB shipping point. Antique Furniture, Inc. prepaid $50 of shipping costs and added the amount to the customer's invoice.
	7	Issued a credit memo to the customer acknowledging the return of $225 of damaged goods.
	16	Received payment in full from the customer for the April 3 invoice.

E5-6B. Journalizing inventory purchases, sales, returns, and freight transactions (*Learning Objectives 3, 4, & 5*) 15–20 min.

The following transactions occurred during April 2013, for Sandy Salon Products, Inc.:

Apr	3	Purchased $3,400 of goods on account, terms 1/15, n/30, FOB shipping point.
	6	Returned $500 of defective merchandise purchased on April 3.
	8	Paid freight charges of $130 for delivery of goods purchased on April 3.
	11	Sold $2,800 of inventory to a customer on account, terms 3/15, n/45, FOB shipping point. The cost of the goods was $1,600.
	12	Paid amount owed on the April 3 purchase.
	18	Granted a $225 sales allowance on the April 11 sale because the goods were the wrong colour.
	25	Received payment in full from customer for the April 11 sale.

Requirement

1. Journalize all necessary transactions for Sandy Salon Products, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

E5-7B. Calculate multi-step income statement items (*Learning Objective 6*) 10–15 min.

Consider the following incomplete table of a merchandiser's profit data:

Sales	Sales Discounts	Net Sales	Cost of Goods Sold	Gross Profit
$ (a)	$1,700	$ (b)	$67,500	$37,700
89,600	2,900	(c)	55,700	(d)
103,000	(e)	94,300	(f)	31,500
(g)	1,400	88,000	51,900	(h)

Requirement

1. Complete the table by computing the missing amounts.

E5-8B. Prepare a single-step income statement (*Learning Objective 6*) 10–15 min.

The account balances for Great Gadget, Inc. for the year ended December 31, 2013, are presented next in random order:

Cash	$ 9,300	Cost of Goods Sold	$135,000
Equipment	39,800	Accumulated Depreciation, Equipment	13,700
Accounts Payable	6,300	Unearned Revenues	1,900
Common Shares	25,000	Sales Revenue	257,000
Long-Term Notes Payable	35,000	Accounts Receivable	4,500
General Expenses	18,200	Accumulated Depreciation, Building	25,900
Wages Payable	1,300	Mortgage Payable (Long-Term)	43,500
Supplies	3,300	Dividends	41,000
Building	130,000	Sales Discounts	1,500
Sales Returns and Allowances	2,900	Selling Expenses	43,500
Prepaid Rent	2,600		
Retained Earnings	25,700		
Inventory	3,700		

Requirements

1. Prepare Great Gadget's *single-step* income statement.
2. Would you recommend the use of the single-step income statement format by a merchandiser? Why?

E5-9B. Prepare a multi-step income statement; calculate gross profit percentage (*Learning Objectives 6 & 7*) 15–20 min.

Use the data for Great Gadget, Inc. from E5-8B.

Requirements

1. Prepare Great Gadget's *multi-step* income statement.
2. Calculate the gross profit percentage.
3. The gross profit percentage for 2012 was 52.3%. Did the gross profit percentage improve or deteriorate during 2013?

E5-10B. Prepare a classified balance sheet; calculate current ratio (*Learning Objectives 6 & 7*) 15–20 min.

Use the data for Great Gadget, Inc. from E5-8B.

Requirements

1. Prepare Great Gadget's classified balance sheet. Use the account format. The balance shown for retained earnings represents the balance prior to closing the temporary accounts for the year.
2. Calculate the current ratio.
3. The current ratio for 2012 was 3.62. Did the current ratio improve or deteriorate during 2013?

E5-11B. Calculate gross profit percentage and current ratio (*Learning Objective 7*) 10–15 min.

Sunny Day Sunlamps, Inc. had sales revenue of $53 million, sales returns and allowances of $2 million, and sales discounts of $0.3 million in 2013. Cost of goods sold was $23 million, and net income was $12 million for the year. At December 31, the company had total assets of $33 million, of which total current assets amounted to $13 million. Sunny Day Sunlamps' current liabilities were $7 million and its long-term liabilities were $4 million.

Requirement

1. Compute Sunny Day Sunlamps' gross profit percentage and current ratio for 2013.

EXERCISES (ALTERNATES 1, 2, AND 3)

These alternative exercise sets are available for your practice benefit at ***www.myaccountinglab.com***

PROBLEMS (GROUP A)

P5-1A. Journalizing inventory purchases, returns, and freight transactions (*Learning Objective 3 & 5*) 15–20 min.

The following purchase-related transactions for Axiom, Inc. occurred during the month of February.

Feb	3	Purchased $5,400 of merchandise, paid cash.
	9	Purchased $650 of supplies on account from Supplies Unlimited, terms n/30, FOB destination.
	16	Purchased $6,800 of merchandise on account from A to Z, Inc., terms 2/15, n/30, FOB shipping point.
	22	Received a credit memo in the amount of $1,200 from A to Z, Inc. for damaged goods from the February 16 purchase that were returned.
	28	Paid for the supplies purchased on February 9.
	28	Paid A to Z, Inc. in full for the February 16 purchase.

Requirement

1. Journalize all necessary transactions for Axiom, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

P5-2A. Journalizing inventory sales, returns, and freight transactions (*Learning Objectives 3 & 5*) 15–20 min.

The following sale-related transactions for PDR, Inc. occurred during the month of June.

Jun	3	Sold $3,200 (cost $2,100) of merchandise on account to J. Henderson, terms 2/15, n/45, FOB destination.
	4	Paid $250 to ship the goods sold on June 3 to J. Henderson.
	10	Sold $1,800 (cost $1,200) of merchandise to cash customers.
	17	Received payment in full from J. Henderson for the June 3 sale.
	22	Sold $4,700 (cost $3,100) of merchandise to M. Perez, terms 3/10, n/30, FOB shipping point.
	26	Granted M. Perez a $600 allowance on the June 22 sale due to minor defects in the goods shipped.
	30	Received payment in full from M. Perez for the June 22 sale.

Requirement

1. Journalize all necessary transactions for PDR, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

P5-3A. Journalizing inventory purchases, sales, returns, and freight transactions (*Learning Objectives 3, 4, & 5*) 20–25 min.

The following transactions occurred between Kinzer Furniture and M & L Furniture Warehouse during May of the current year:

May	4	Kinzer Furniture purchased $5,800 of merchandise from M & L Furniture Warehouse on account, terms 2/15, n/30, FOB shipping point. The goods cost M & L Furniture Warehouse $3,300.
	7	Kinzer Furniture paid a $125 freight bill for delivery of the goods purchased on May 4.
	10	Kinzer Furniture returned $1,400 of the merchandise purchased on May 4. The goods cost M & L Furniture Warehouse $800.
	18	Kinzer Furniture paid $2,000 of the May 4 invoice less the discount.
	31	Kinzer Furniture paid the remaining amount owed on the May 4 invoice.

Requirements

1. Journalize all necessary transactions for Kinzer Furniture, using
   (a) The perpetual inventory system
   (b) The periodic inventory system
2. Journalize these transactions on the books of M & L Furniture Warehouse, using
   (a) The perpetual inventory system
   (b) The periodic inventory system

   Omit explanations.

P5-4A. Journalizing inventory purchases, sales, returns, and freight transactions; calculate gross profit (*Learning Objectives 3, 4, 5, & 6*) 25–30 min.

The following transactions for Liberty Tire, Co. occurred during October:

Oct	4	Purchased $5,900 of merchandise on account from Firerock Tire, terms 2/15, n/45, FOB shipping point. Firerock Tire prepaid the $300 shipping cost and added the amount to the invoice.
	7	Purchased $350 of supplies on account from Office Maxx, terms 2/10, n/30, FOB destination.
	9	Sold $950 (cost, $500) of merchandise on account to L. Simpson, terms 3/15, n/45, FOB destination.
	11	Paid $75 freight charges to deliver goods to L. Simpson.
	13	Returned $1,400 of the merchandise purchased on October 4 and received a credit.
	15	Sold $650 (cost, $350) of merchandise to cash customers.
	16	Paid for the supplies purchased on October 7.
	18	Paid Firerock Tire the amount due from the October 4 purchase in full.
	20	L. Simpson returned $175 (cost, $100) of merchandise from the October 9 sale.
	22	Purchased $2,100 of inventory. Paid cash.
	23	Received payment in full from L. Simpson for the October 9 sale.

Requirements

1. Journalize the transactions on the books of Liberty Tire, Co. using
   (a) The perpetual inventory system
   (b) The periodic inventory system.
2. What was Liberty Tire's gross profit for the month of October?

Quick solution:

2. Gross Profit for the month of October = $651.75.

P5-5A. Prepare a multi-step income statement; calculate gross profit percentage (*Learning Objectives 6 & 7*) 20–25 min.

The adjusted trial balance for Sparky's Electrical Supply, Inc. as of November 30, 2013, is presented next:

Sparky's Electrical Supply, Inc.
Trial Balance
November 30, 2013

ACCOUNT	DEBIT	CREDIT
Cash	$ 15,000	
Accounts Receivable	37,300	
Inventory	18,500	
Supplies	900	
Equipment	68,000	
Accumulated Depreciation, Equipment		$ 8,000
Accounts Payable		12,900
Unearned Sales Revenue		5,300
Note Payable, Long-Term		15,000
Common Shares		10,000
Retained Earnings		73,300
Dividends	22,000	
Sales Revenue		193,200
Sales Returns and Allowances	8,700	
Sales Discounts	2,600	
Cost of Goods Sold	103,400	
Selling Expense	25,200	
General Expense	16,100	
Total	$317,700	$317,700

Requirements

1. Prepare the multi-step income statement for November for Sparky's Electrical Supply, Inc.
2. Calculate the gross profit percentage for November for Sparky's Electrical Supply, Inc.
3. What does Sparky's Electrical Supply Inc.'s gross profit percentage mean?

P5-6A. Prepare a multi-step income statement, a statement of retained earnings, and a classified balance sheet (*Learning Objective 6*) 25–30 min.

The account balances for the year ended December 31, 2013, for Williams Industries are listed next:

Sales Revenue	$322,800	Cost of Goods Sold	$158,400
Equipment	104,000	Accumulated Depreciation, Equipment	26,400
Accounts Payable	16,500	Unearned Sales Revenue	2,500
Sales Discounts	2,200	Prepaid Rent	1,200
Advertising Expense	12,600	Office Salaries Expense	52,000
Interest Expense	1,700	Accumulated Depreciation, Building	40,500
Wages Payable	1,600	Rent Expense	5,800
Accounts Receivable	6,900	Dividends	14,000
Building	140,000	Cash	7,800
Sales Returns and Allowances	6,700	Retained Earnings	87,600
Common Shares	35,000	Delivery Expense	1,300
Utilities Expense	10,300	Insurance Expense	5,700
Inventory	16,400	Mortgage Payable (Long-Term)	37,000
Commission Expense	22,300		
Supplies	600		

Requirements

1. Prepare Williams' Industries' *multi-step* income statement.
2. Prepare Williams' Industries' statement of retained earnings.
3. Prepare Williams' Industries' classified balance sheet in *report form*.

P5-7A. Calculate gross profit percentage and current ratio (*Learning Objective 7*) 20–25 min.

The account balances for the year ended December 31, 2013, for Williams Industries are listed next:

Sales Revenue	$322,800	Cost of Goods Sold	$158,400
Equipment	104,000	Accumulated Depreciation, Equipment	26,400
Accounts Payable	16,500	Unearned Sales Revenue	2,500
Sales Discounts	2,200	Prepaid Rent	1,200
Advertising Expense	12,600	Office Salaries Expense	52,000
Interest Expense	1,700	Accumulated Depreciation, Building	40,500
Wages Payable	1,600	Rent Expense	5,800
Accounts Receivable	6,900	Dividends	14,000
Building	140,000	Cash	7,800
Sales Returns and Allowances	6,700	Retained Earnings	87,600
Common Shares	35,000	Delivery Expense	1,300
Utilities Expense	10,300	Insurance Expense	5,700
Inventory	16,400	Mortgage Payable	37,000
Commission Expense	22,300		
Supplies	600		

Requirements

1. Calculate the gross profit percentage for Williams Industries for the year.
2. The gross profit percentage for 2012 was 51.3%. Did the gross profit percentage improve or deteriorate during 2013?

3. Calculate the current ratio for Williams Industries.

4. The current ratio for 2012 was 1.47. Did the current ratio improve or deteriorate during 2013?

PROBLEMS (GROUP B)

P5-1B. Journalizing inventory purchases, returns, and freight transactions (*Learning Objectives 3 & 5*) 15–20 min.

The following purchase-related transactions for Lavery, Inc. occurred during the month of September.

Sep	3	Purchased $5,100 of merchandise, paid cash.
	9	Purchased $800 of supplies on account from Chandler Unlimited. terms n/30, FOB destination.
	16	Purchased $4,300 of merchandise on account from Garden Supplies, Inc.. terms 3/15, n/30, FOB shipping point.
	22	Received a credit memo in the amount of $1,100 from Garden Supplies, Inc. for damaged goods from the Sep 16 purchase that were returned.
	30	Paid for the supplies purchased on Sep 9.
	30	Paid Garden Supplies, Inc. in full for the Sep 16 purchase.

Requirement

1. Journalize all necessary transactions for Lavery, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

P5-2B. Journalizing inventory sales, returns, and freight transactions (*Learning Objectives 3 & 5*) 15–20 min.

The following sale-related transactions for Beautiful Decor, Inc. occurred during the month of April.

Apr	3	Sold $3,600 (cost $1,700) of merchandise on account to A. Klecans, terms 3/15, n/45, FOB destination.
	4	Paid $75 to ship the goods sold on April 3 to A. Klecans.
	10	Sold $2,700 (cost $1,200) of merchandise to cash customers.
	17	Received payment in full from A. Klecans for the April 3 sale.
	22	Sold $5,100 (cost $2,500) of merchandise to M. Perez, terms 2/10, n/30, FOB shipping point.
	26	Granted M. Perez a $200 allowance on the April 22 sale due to minor defects in the goods shipped.
	30	Received payment in full from M. Perez for the April 22 sale.

Requirement

1. Journalize all necessary transactions for Beautiful Decor, Inc. using (1) the perpetual inventory system, and (2) the periodic inventory system. Omit explanations.

P5-3B. Journalizing inventory purchases, sales, returns, and freight transactions (*Learning Objectives 3, 4, & 5*) 20–25 min.

The following transactions occurred between Retro Furniture and E & S Furniture Warehouse during October of the current year:

Oct	4	Retro Furniture purchased $8,000 of merchandise from E & S Furniture Warehouse on account, terms 1/15, n/30. FOB shipping point. The goods cost E & S Furniture Warehouse $2,900.
	7	Retro Furniture paid a $200 freight bill for delivery of the goods purchased on October 4.
	10	Retro Furniture returned $1,000 of the merchandise purchased on October 4. The goods cost E & S Furniture Warehouse $450.
	18	Retro Furniture paid $2,000 of the October 4 invoice less the discount.
	31	Retro Furniture paid the remaining amount owed on the October 4 invoice.

Requirements

1. Journalize all necessary transactions for Retro Furniture, using
   (a) The perpetual inventory system
   (b) The periodic inventory system
2. Journalize these transactions on the books of E & S Furniture Warehouse, using
   (a) The perpetual inventory system
   (b) The periodic inventory system

P5-4B. Journalizing inventory purchases, sales, returns, and freight transactions; calculate gross profit (*Learning Objectives 3, 4, 5, & 6*) 25–30 min.

The following transactions for Best Deal Tire, Co. occurred during May:

May	4	Purchased $5,400 of merchandise on account from Bargain Tire, terms 3/15, n/45, FOB shipping point. Bargain Tire prepaid the $125 shipping cost and added the amount to the invoice.
	7	Purchased $375 of supplies on account from Office Maxx, terms 3/10, n/30, FOB destination.
	9	Sold $950 (cost, $250) of merchandise on account to W. Furmick, terms 3/15, n/45, FOB destination.
	11	Paid $25 freight charges to deliver goods to W. Furmick.
	13	Returned $600 of the merchandise purchased on May 4 and received a credit.
	15	Sold $900 (cost, $350) of merchandise to cash customers.
	16	Paid for the supplies purchased on May 7.
	18	Paid Bargain Tire the amount due from the May 4 purchase in full.
	20	W. Furmick returned $175 (cost, $100) of merchandise from the May 9 sale.
	22	Purchased $3,900 of inventory. Paid cash.
	23	Received payment in full from W. Furmick for the May 9 sale.

Requirements

1. Journalize the transactions on the books of Best Deal Tire, Co. using (1) the perpetual inventory system, and (2) the periodic inventory system.
2. What was Best Deal Tire's gross profit for the month of May?

P5-5B. Prepare a multi-step income statement; calculate gross profit percentage (*Learning Objectives 6 & 7*) 20–25 min.

The adjusted trial balance for CED Electric, Inc. as of June 30, 2013, is presented next:

CED Electric, Inc.
Trial Balance
June 30, 2013

ACCOUNT	DEBIT	CREDIT
Cash	$ 13,600	
Accounts Receivable	32,600	
Inventory	19,600	
Supplies	2,600	
Equipment	69,000	
Accumulated Depreciation, Equipment		$ 13,700
Accounts Payable		5,100
Unearned Sales Revenue		2,800
Note Payable, Long-Term		40,000
Common Shares		25,000
Retained Earnings		68,200
Dividends	48,000	
Sales Revenues		197,500
Sales Returns and Allowances	4,800	
Sales Discount	3,100	
Cost of Goods Sold	101,400	
Selling Expense	37,000	
General Expense	20,600	
Total	$352,300	$352,300

Requirements

1. Prepare the multi-step income statement for June for CED Electric, Inc.
2. Calculate the gross profit percentage for June for CED Electric, Inc.
3. What does CED Electric Inc.'s gross profit percentage mean?

P5-6B. Prepare a multi-step income statement, a statement of retained earnings, and a classified balance sheet (*Learning Objective* 6) 25–30 min.

The accounts for the year ended March 31, 2013, for Clark Industries, Inc. are listed next:

Sales Revenue	$275,100	Cost of Goods Sold	$119,000
Equipment	27,000	Accumulated Depreciation, Equipment	13,000
Accounts Payable	16,500	Unearned Sales Revenue	2,500
Sales Discounts	2,500	Prepaid Rent	5,000
Advertising Expense	11,500	Office Salaries Expense	54,000
Interest Expense	700	Accumulated Depreciation, Building	52,500
Wages Payable	1,000	Rent Expense	5,200
Accounts Receivable	8,800	Dividends	12,000
Building	190,000	Cash	22,500
Sales Returns and Allowances	4,900	Retained Earnings	112,800
Common Shares	35,000	Delivery Expense	1,200
Utilities Expense	14,000	Insurance Expense	10,200
Inventory	29,000	Mortgage Payable (Long-Term)	42,000
Commission Expense	31,700		
Supplies	1,200		

Requirements

1. Prepare Clark Industries' *multi-step* income statement.
2. Prepare Clark Industries' statement of retained earnings.
3. Prepare Clark Industries' classified balance sheet in *report form*.

P5-7B. Calculate gross profit percentage and current ratio (*Learning Objective 7*) 20–25 min.

The list of accounts and balances for Clark Industries at March 31, 2013, are presented next:

Sales Revenue	$275,100	Cost of Goods Sold	$119,000
Equipment	27,000	Accumulated Depreciation, Equipment	13,000
Accounts Payable	16,500	Unearned Sales Revenue	2,500
Sales Discounts	2,500	Prepaid Rent	5,000
Advertising Expense	11,500	Office Salaries Expense	54,000
Interest Expense	700	Accumulated Depreciation, Building	52,500
Wages Payable	1,000	Rent Expense	5,200
Accounts Receivable	8,800	Dividends	12,000
Building	190,000	Cash	22,500
Sales Returns and Allowances	4,900	Retained Earnings	112,800
Common Shares	35,000	Delivery Expense	1,200
Utilities Expense	14,000	Insurance Expense	10,200
Inventory	29,000	Mortgage Payable (Long-Term)	42,000
Commission Expense	31,700		
Supplies	1,200		

Requirements

1. Calculate the gross profit percentage for Clark Industries for the year.
2. The gross profit percentage for 2012 was 39.1%. Did the gross profit percentage improve or deteriorate during 2013?
3. Calculate the current ratio for Clark Industries.
4. The current ratio for 2012 was 2.33. Did the current ratio improve or deteriorate during 2013?

PROBLEMS (ALTERNATES 1, 2, AND 3)

These alternative problem sets are available for your practice benefit at ***www.myaccountinglab.com***

CONTINUING EXERCISE

Let's continue our accounting for Graham's Yard Care, Inc. from Chapter 3. Starting in July, Graham's Yard Care, Inc. has begun selling plants that it purchases from a wholesaler. During July, Graham's Yard Care, Inc. completed the following transactions:

Jul	2	Completed lawn service and received cash of $500.
	5	Purchased 100 plants on account for inventory, $250, plus freight in of $10.
	15	Sold 40 plants on account, $400 (cost $104).
	17	Consulted with a client on landscaping design for a fee of $150 on account.
	20	Purchased 100 plants on account for inventory, $300.
	21	Paid on account, $100.
	25	Sold 100 plants for cash, $700 (cost $276).
	31	Recorded the following adjusting entries: Accrued salaries for the month of July equal $225 Depreciation on equipment $30 Physical count of plant inventory, 50 plants (cost $150)

Refer to the T-accounts for Graham's Yard Care, Inc. from the Continuing Exercise in Chapter 3.

Requirements

1. Journalize and post the July transactions., using the perpetual inventory system. Omit explanations. Compute each account balance, and denote the balance as *Bal*. Open additional accounts as necessary.
2. Prepare the July income statement of Graham's Yard Care, Inc. using the single-step format.

CONTINUING PROBLEM

In this problem, we continue the accounting for Aqua Elite, Inc. from Chapter 3. On August 1, Aqua Elite, Inc. expanded its business and began selling and installing swimming pools and spas. The post-closing trial balance for Aqua Elite, Inc. as of July 31, 2013, is presented next.

Aqua Elite, Inc.
Trial Balance
July 31, 2013

ACCOUNT	DEBIT	CREDIT
Cash	$17,380	
Accounts Receivable	5,400	
Supplies	350	
Prepaid Rent	3,600	
Land	15,000	
Furniture	3,300	
Accumulated Depreciation, Furniture		$ 210
Equipment	4,700	
Accumulated Depreciation, Equipment		400
Vehicles	31,000	
Accumulated Depreciation, Vehicles		650
Accounts Payable		1,840
Salary Payable		675
Unearned Service Revenue		2,800
Notes Payable		31,000
Common Shares		38,500
Retained Earnings		4,655
Total	$80,730	$80,730

The following transactions occurred during the month of August:

Aug	2	Paid the receptionist's salary, which was accrued on July 31.
	3	Purchased $20,600 of merchandise on account from the Spa Superstore, terms 3/15, n/45, FOB shipping point.
	5	Purchased $750 of supplies. Paid cash.
	6	Paid freight charges of $475 related to the August 3 purchase.
	8	Sold a spa for $5,800 (cost, $3,600) on account to R. Tanaka, terms 2/15, n/30, FOB shipping point.
	10	Purchased office furniture for $1,200. Paid cash.
	11	Paid advertising expense, $625.
	12	Returned a defective spa, which was purchased on August 3. Received a $3,400 credit from the Spa Superstore.
	13	Sold a spa for $6,750 (cost, $3,360) to a cash customer.
	15	Granted R. Tanaka a $300 allowance because of imperfections she detected upon receiving her spa.
	16	Paid receptionist's salary, $675.
	17	Paid the Spa Superstore the amount due from the August 3 purchase in full.
	19	Purchased $12,100 of inventory on account from Pool Universe, terms 2/10, n/30, FOB destination.
	21	Sold an above-ground pool for $13,700 (cost, $8,500) on account to B. Wagoner, terms 2/10, n/30, FOB destination.
	22	Received payment in full from R. Tanaka for the August 8 sale.
	24	Paid freight charges of $560 to have the pool sold to B. Wagoner on August 21 delivered.
	25	Purchased equipment on account from Betterbuy, Inc. for $2,600, terms n/30, FOB destination.
	27	Received payment in full from B. Wagoner for the August 21 sale.
	28	Paid in full the invoice from the August 19 purchase from Pool Universe.
	30	Paid monthly utilities, $850.
	31	Paid sales commissions of $1,300 to the sales staff.

Requirements

1. Journalize the transactions that occurred in August, using the perpetual inventory system.
2. Using the four-column accounts from the continuing problem in Chapter 3, post the transactions to the ledger creating new ledger accounts as necessary; omit posting references. Calculate the new account balances.
3. Prepare the unadjusted trial balance for Aqua Elite, Inc. at the end of August.
4. Journalize and post the adjusting entries for August based on the following adjustment information.
   a. Record the expired rent, $1800.
   b. Supplies on hand, $445.
   c. Depreciation: $575 equipment, $380 furniture, $650 vehicles.
   d. A physical count of inventory revealed $13,387 of inventory on hand.
5. Prepare an adjusted trial balance for Aqua Elite, Inc. at the end of August.
6. Prepare the multi-step income statement, statement of retained earnings, and classified balance sheet for the month of August.
7. Prepare and post closing entries.
8. Prepare a post-closing trial balance for the end of the period.

APPLY YOUR KNOWLEDGE

ETHICS IN ACTION

Case 1. Tim Jackson works as a salesperson at Conway, Inc. In addition to a base monthly salary, Tim receives a commission that is based on the amount of sales that he makes during the month. Tim was hoping to have enough money for a down payment on a new car but sales have been low due to a downturn in the economy. Tim was aware that Conway, Inc. granted credit terms of 2/10, n/30 to its credit customers. In addition, Tim knew that Conway, Inc. had a "no questions asked" return policy. Based on this knowledge, Tim had an idea. Tim contacted a regular customer and convinced the customer to make a substantial purchase of merchandise so that he could earn the commission on the sale. Tim explained to the customer that they would not have to pay for the goods for thirty days and that they could return part, or all, of the goods prior to paying for them. However, Tim asked the customer not to return any of the goods until the following month to ensure that he would earn the full commission.

Requirements

1. Do you feel Tim acted unethically? Why or why not?
2. How can Conway, Inc. deter actions like Tim's?

Case 2. Tina Adams owns and operates the Cottage Café. Tina has requested a credit application from UMT, Inc., a major food supplier, that she hopes to begin purchasing inventory from. UMT, Inc. has requested that Tina submit a full set of financial statements for the Cottage Café with the credit application. Tina is concerned because the most recent balance sheet for the Cottage Café reflects a current ratio of 1.24. Tina has heard that most creditors like to see a current ratio that is 1.5 or higher. To increase the Cottage Café's current ratio, Tina has convinced her parents to loan the business $25,000 on an 18-month long-term note payable. Tina's parents are apprehensive about having their money "tied up" for over a year. Tina reassured them that even though the note is an 18-month note, the Cottage Café can, and probably will, repay the $25,000 sooner.

Requirements

1. Discuss the ethical issues related to the loan from Tina's parents.
2. Why do you think creditors like to see current ratios of 1.5 or higher?

KNOW YOUR BUSINESS

FINANCIAL ANALYSIS

Purpose: To help familiarize you with the financial reporting of a real company to further your understanding of the chapter material you are learning.

This case uses both the income statement (statement of operations) and the balance sheet of Bombardier Inc. in MyAccountingLab.

Requirements

1. What income statement format does Bombardier Inc. use? How can you tell?
2. Calculate the gross profit ratio for Bombardier Inc. for 2011 and 2010. Has the gross profit rate improved or deteriorated? (Hints on how this is calculated were provided in Chapter 2 questions.)
3. Does Bombarider Inc. report a classified balance sheet? How can you tell? Why do you think Bombardier reports the balance sheet in this manner?

INDUSTRY ANALYSIS

Purpose: To help you understand and compare the performance of two companies in the same industry.

Find the Bombardier Annual Report located in MyAccountingLab and go to the financial statements. Now access the 2010 annual report for The Boeing Company. To do this from the internet, go to their webpage for the Investor Relations at *http://www.boeing.com/companyoffices/financial/quarterly.htm* and, under Annual Report, go to the 2010 Annual Report.

Requirement

1. Calculate the current ratio for Boeing for 2010 and 2009. Has the current ratio improved or deteriorated? Comment on how Boeing determines what is in current? (Hint: See Note 1—Operating Cycle). Which balance sheet classification presentation do you find more useful: Boeing's or Bombardier's? Why?
2. Which of these companies is also involved in providing customer financing? How did you determine this? Which accounts on the consolidated balance sheets indicate this? Which accounts on the consolidated statements of income (or operations) might also indicate this?

SMALL BUSINESS ANALYSIS

Purpose: To help you understand the importance of cash flows in the operation of a small business.

The end of the year is approaching. You're going to meet with your CA next week to do some end-of-the-year tax planning, so in preparation for that meeting you look at your last month's income statement. You know that you've had a pretty good year, which means that you're going to have to pay some income taxes. But you know if you can get your taxable income down, you won't have to pay as much in income taxes.

You remember that one of your suppliers was offering a pretty good discount if you purchased from the company in bulk. The only problem is you have to pay for the purchases at the time of purchase. Knowing that you want to decrease your taxable income, you call up the supplier and place a large order and write the supplier a cheque.

At your meeting with the CA, you tell of the large inventory purchase for cash that you just made and how much income tax that will save you on this year's income tax return. The CA has a rather troubled look on his face; that look usually means you've made some kind of an error. So you pose this question to him:

"Steve, you got that look on your face right after I told you about the big inventory purchase that I made. Even though I used up a lot of my available cash, the reason I did it was to save money on my tax return. A big purchase like that has to knock down my taxable income pretty good, huh? And besides, I got these products for a really good price, which means I'll make more profit when I sell them. So why do you have that look? Did I mess up?"

Requirement

1. If you were the CA, how would you respond to this client? Is the large inventory purchase going to have any effect on his income statement? What about the fact that he paid for this large purchase in cash? Was that a good idea to use a large portion of available cash for a purchase like this? Keeping in mind that inventory can have a significant amount of carrying cost (storage, personnel, opportunity cost of the money, etc.) would you tell your client that this was a good thing that he did, or not?

WRITTEN COMMUNICATION

You just got a letter from one of your good customers complaining about the shipment of your product that he or she just received. Football season is approaching and the customer had ordered a large shipment of regulation size footballs. Instead, he or she received youth size footballs for half of the order. The customer is asking you what can be done about this mistake. Knowing that this client is located halfway across the country, it's not feasible to just have him or her drop by your facility and trade the footballs.

The customer also had a question about a line item on his or her invoice under shipping terms. It said FOB Destination and the customer noticed that he or she was charged freight, which the customer normally doesn't have to pay. The customer wants to know if that is correct.

Requirement

1. Write a letter to your customer explaining how you intend to handle this purchase return or this purchase allowance (you choose which one you're going to do). Explain the accounting forms that will need to be prepared to document this transaction. Also address the customer's concern about the shipping terms.

Self Check Answers

1. d 2. a 3. b 4. c 5. a 6. a 7. d 8. b 9. c 10. a

SCAN THIS