

# Chapter 5

# Accounting for Merchandising Operations

## STUDY OBJECTIVES

After studying this chapter, you should be able to:

- 1 Identify the differences between service and merchandising companies.
- 2 Explain the recording of purchases under a perpetual inventory system.
- 3 Explain the recording of sales revenues under a perpetual inventory system.
- 4 Explain the steps in the accounting cycle for a merchandising company.
- 5 Distinguish between a multiple-step and a single-step income statement.
- 6 Explain the computation and importance of gross profit.



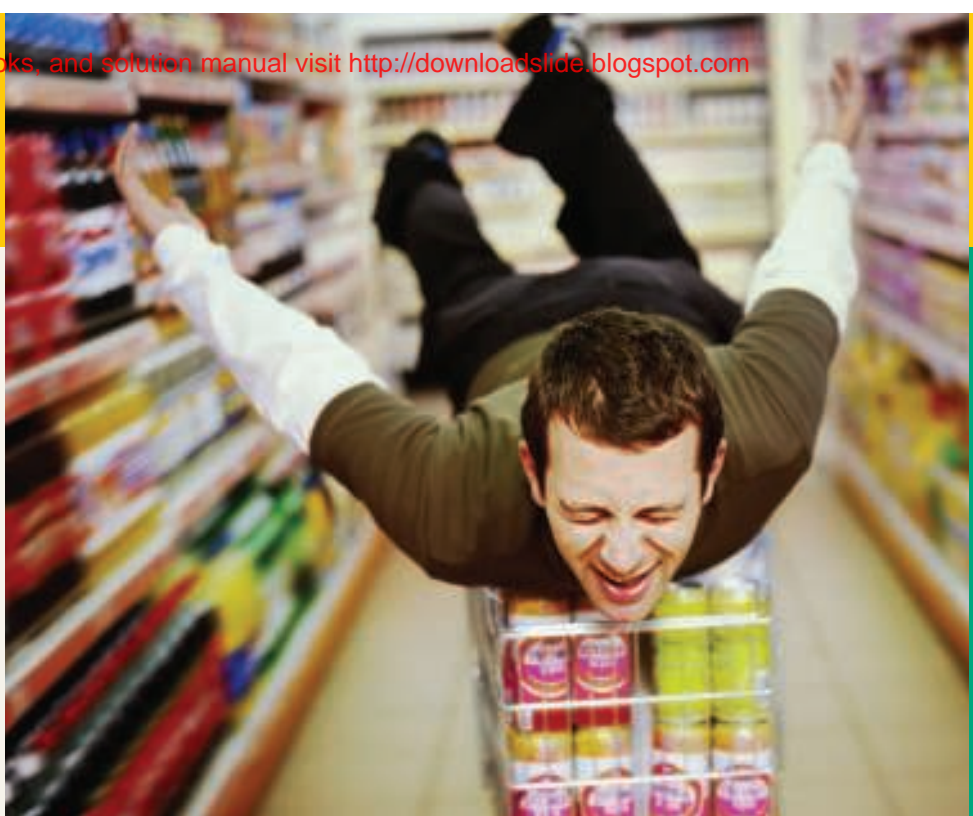
## The Navigator

Scan <b>Study Objectives</b>	■
Read <b>Feature Story</b>	■
Read <b>Preview</b>	■
Read text and answer <b>DO IT!</b> p. 207 ■ p. 210 ■ p. 213 ■ p. 218	
Work <b>Comprehensive DO IT!</b> p. 219	■
Review <b>Summary of Study Objectives</b>	■
Answer <b>Self-Study Questions</b>	■
Complete <b>Assignments</b>	■

## Feature Story

### WHO DOESN'T SHOP AT WAL-MART?

In his book *The End of Work*, Jeremy Rifkin notes that until the 20th century the word *consumption* evoked negative images. To be labeled a "consumer" was an insult. In fact, one of the deadliest diseases in history, tuberculosis, was often referred to as "consumption." Twentieth-century merchants realized, however, that in order to prosper, they had to convince people of the need for things not previously needed. For example, **General Motors** made annual changes in its cars so that people would be discontented with the cars they already owned. Thus began consumerism.



Today consumption describes the U.S. lifestyle in a nutshell. We consume twice as much today per person as we did at the end of World War II. The amount of U.S. retail space per person is vastly greater than that of any other country. It appears that we live to shop.

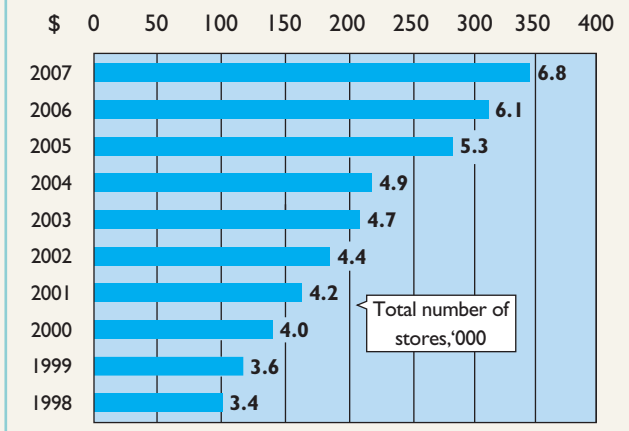
The first great retail giant was **Sears, Roebuck and Company**. It started as a catalog company enabling people in rural areas to buy things by mail. For decades it was the uncontested merchandising leader.

Today **Wal-Mart** ([www.walmart.com](http://www.walmart.com)) is the undisputed champion provider of basic (and perhaps not-so-basic) human needs. Wal-Mart opened its first store in 1962, and it now has more than 6,000 stores, serving more than 100 million customers every week. A key cause of Wal-Mart's incredible growth is its amazing system of inventory control and distribution. Wal-Mart has a management information system that employs six satellite channels, from which company computers receive 8.4 million updates every minute on what items customers buy and the relationship among items sold to each person.

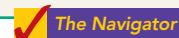
Measured by sales revenues, Wal-Mart is the largest company in the world. In six years it went from selling almost no groceries to being America's largest grocery retailer.

It would appear that things have never looked better at Wal-Mart. On the other hand, a *Wall Street Journal* article entitled "How to Sell More to Those Who Think It's Cool to Be Frugal" suggests that consumerism as a way of life might be dying. Don't bet your wide-screen TV on it, though.

**Wal-Mart net sales, years ending January 31st (billions)**



Sources: "How Big Can It Grow?" *The Economist*, April 17, 2004, pp. 67-69; and [www.walmart.com](http://www.walmart.com) (accessed March 17, 2008).

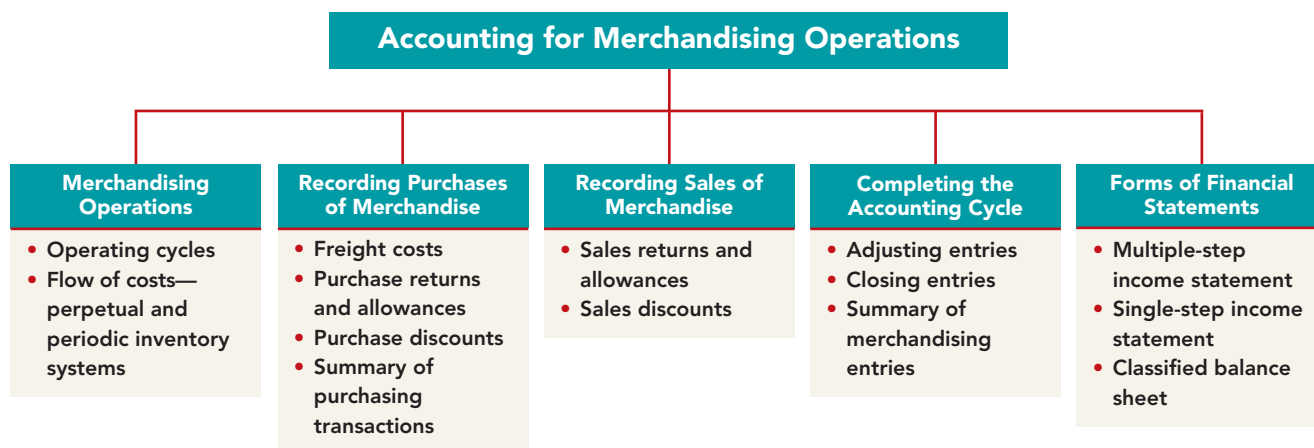


## Inside Chapter 5...

- **Morrow Snowboards Improves Its Stock Appeal** (p. 203)
- **Should Publishers Have Liberal Return Policies?** (p. 210)

## Preview of Chapter 5

Merchandising is one of the largest and most influential industries in the United States. It is likely that a number of you will work for a merchandiser. Therefore, understanding the financial statements of merchandising companies is important. In this chapter you will learn the basics about reporting merchandising transactions. In addition, you will learn how to prepare and analyze a commonly used form of the income statement—the multiple-step income statement. The content and organization of the chapter are as follows.



## MERCHANDISING OPERATIONS

### STUDY OBJECTIVE 1

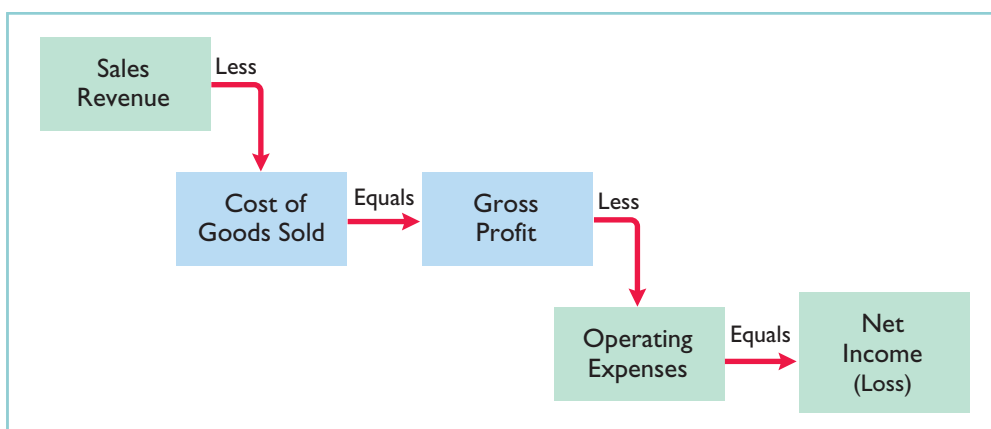
Identify the differences between service and merchandising companies.

Wal-Mart, Kmart, and Target are called merchandising companies because they buy and sell merchandise rather than perform services as their primary source of revenue. Merchandising companies that purchase and sell directly to consumers are called **retailers**. Merchandising companies that sell to retailers are known as **wholesalers**. For example, retailer

Walgreens might buy goods from wholesaler McKesson; retailer Office Depot might buy office supplies from wholesaler United Stationers. The primary source of revenues for merchandising companies is the sale of merchandise, often referred to simply as **sales revenue** or **sales**. A merchandising company has two categories of expenses: cost of goods sold and operating expenses.

**Cost of goods sold** is the total cost of merchandise sold during the period. This expense is directly related to the revenue recognized from the sale of goods. Illustration 5-1 shows the income measurement process for a merchandising

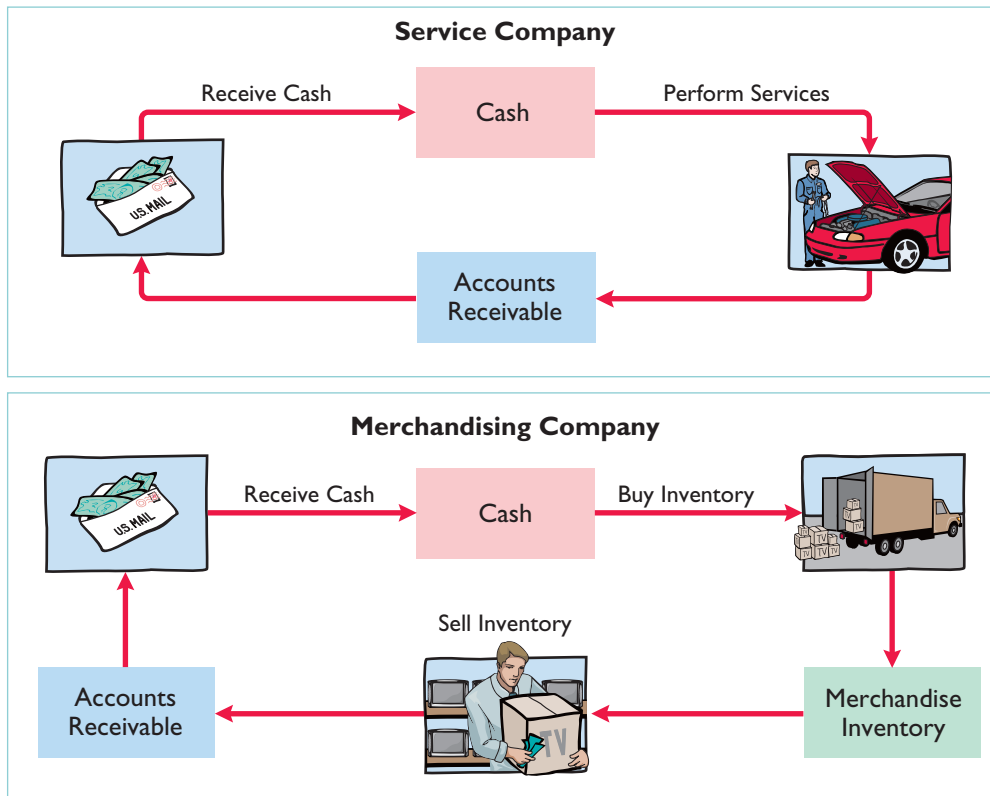
**Illustration 5-1**  
Income measurement process for a merchandising company



company. The items in the two blue boxes are unique to a merchandising company; they are not used by a service company.

## Operating Cycles

The operating cycle of a merchandising company ordinarily is longer than that of a service company. The purchase of merchandise inventory and its eventual sale lengthen the cycle. Illustration 5-2 contrasts the operating cycles of service and merchandising companies. Note that the added asset account for a merchandising company is the Merchandise Inventory account. Companies report merchandise inventory as a current asset on the balance sheet.



**Illustration 5-2**

Operating cycles for a service company and a merchandising company

## Flow of Costs

The flow of costs for a merchandising company is as follows: Beginning inventory is added to the cost of goods purchased to arrive at cost of goods available for sale. Cost of goods available for sale is assigned to the cost of goods sold (goods sold this period) and ending inventory (goods to be sold in the future). Illustration 5-3 (page 202) describes these relationships. Companies use one of two systems to account for inventory: a **perpetual inventory system** or a **periodic inventory system**.

### PERPETUAL SYSTEM

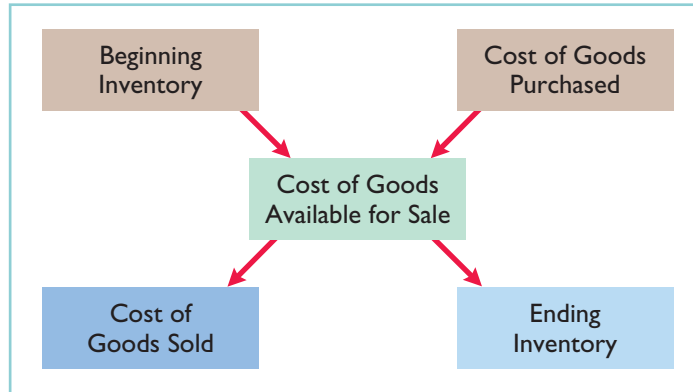
In a **perpetual inventory system**, companies keep detailed records of the cost of each inventory purchase and sale. These records continuously—perpetually—show the inventory that should be on hand for every item. For example, a **Ford** dealership has separate inventory records for each automobile, truck, and van on its lot and showroom floor. Similarly, a **Kroger** grocery store uses bar codes and optical

### HELPFUL HINT

For control purposes companies take a physical inventory count under the perpetual system, even though it is not needed to determine cost of goods sold.

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**Illustration 5-3**  
Flow of costs



scanners to keep a daily running record of every box of cereal and every jar of jelly that it buys and sells. Under a perpetual inventory system, a company determines the cost of goods sold **each time a sale occurs**.

**PERIODIC SYSTEM**

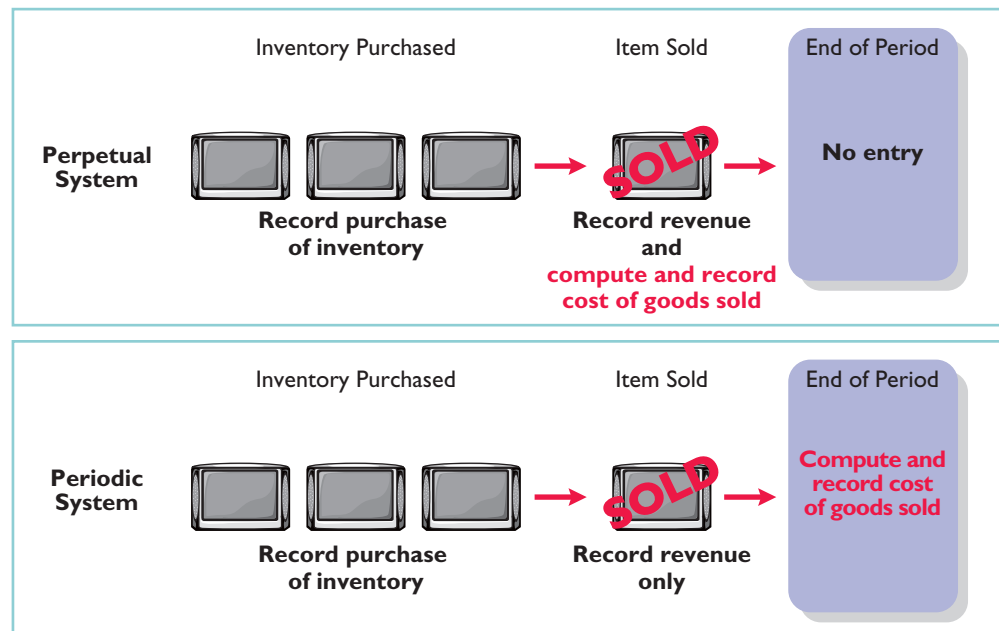
In a **periodic inventory system**, companies do not keep detailed inventory records of the goods on hand throughout the period. Instead, they determine the cost of goods sold **only at the end of the accounting period**—that is, periodically. At that point, the company takes a physical inventory count to determine the cost of goods on hand.

To determine the cost of goods sold under a periodic inventory system, the following steps are necessary:

1. Determine the cost of goods on hand at the beginning of the accounting period.
2. Add to it the cost of goods purchased.
3. Subtract the cost of goods on hand at the end of the accounting period.

Illustration 5-4 graphically compares the sequence of activities and the timing of the cost of goods sold computation under the two inventory systems.

**Illustration 5-4**  
Comparing perpetual and periodic inventory systems



### ADDITIONAL CONSIDERATIONS

Companies that sell merchandise with high unit values, such as automobiles, furniture, and major home appliances, have traditionally used perpetual systems. The growing use of computers and electronic scanners has enabled many more companies to install perpetual inventory systems. The perpetual inventory system is so named because the accounting records continuously—perpetually—show the quantity and cost of the inventory that should be on hand at any time.

A perpetual inventory system provides better control over inventories than a periodic system. Since the inventory records show the quantities that should be on hand, the company can count the goods at any time to see whether the amount of goods actually on hand agrees with the inventory records. If shortages are uncovered, the company can investigate immediately. Although a perpetual inventory system requires additional clerical work and additional cost to maintain the subsidiary records, a computerized system can minimize this cost. As noted in the Feature Story, much of **Wal-Mart's** success is attributed to its sophisticated inventory system.

Some businesses find it either unnecessary or uneconomical to invest in a computerized perpetual inventory system. Many small merchandising businesses, in particular, find that a perpetual inventory system costs more than it is worth. Managers of these businesses can control their merchandise and manage day-to-day operations using a periodic inventory system.

Because the perpetual inventory system is growing in popularity and use, we illustrate it in this chapter. Appendix 5A describes the journal entries for the periodic system.

## INVESTOR INSIGHT



### *Morrow Snowboards Improves Its Stock Appeal*

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



If a perpetual system keeps track of inventory on a daily basis, why do companies ever need to do a physical count?



## RECORDING PURCHASES OF MERCHANDISE

Companies purchase inventory using cash or credit (on account). They normally record purchases when they receive the goods from the seller. Business documents provide written evidence of the transaction. A canceled check or a cash register receipt, for example, indicates the items purchased and amounts paid for each cash purchase. Companies record cash purchases by an increase in Merchandise Inventory and a decrease in Cash.

A **purchase invoice** should support each credit purchase. This invoice indicates the total purchase price and other relevant information. The purchaser uses the

### STUDY OBJECTIVE 2

Explain the recording of purchases under a perpetual inventory system.



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copy of the sales invoice sent by the seller as a purchase invoice. In Illustration 5-5, for example, Sauk Stereo (the buyer) uses as a purchase invoice the sales invoice prepared by PW Audio Supply, Inc. (the seller).

**Illustration 5-5**


Sales invoice used as purchase invoice by Sauk Stereo

**HELPFUL HINT**

To better understand the contents of this invoice, identify these items:

1. Seller
2. Invoice date
3. Purchaser
4. Salesperson
5. Credit terms
6. Freight terms
7. Goods sold: catalog number, description, quantity, price per unit
8. Total invoice amount

INVOICE NO. 731



**PW AUDIO SUPPLY, INC.**  
27 CIRCLE DRIVE  
HARDING, MICHIGAN 48281

**S** Firm Name Sauk Stereo

**O** Attention of James Hoover, Purchasing Agent

**L** Address 125 Main Street

**D** Chelsea Illinois 60915

**T** City State Zip

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

Sauk Stereo makes the following journal entry to record its purchase from PW Audio Supply. The entry increases (debits) Merchandise Inventory and increases (credits) Accounts Payable.

<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 30%; background-color: #008000; color: white; text-align: center; padding: 2px;"><b>A</b></td> <td style="width: 10%; text-align: center;">=</td> <td style="width: 30%; background-color: #4B0082; color: white; text-align: center; padding: 2px;"><b>L</b></td> <td style="width: 10%; text-align: center;">+</td> <td style="width: 17%; background-color: #0000FF; color: white; text-align: center; padding: 2px;"><b>OE</b></td> </tr> </table>	<b>A</b>	=	<b>L</b>	+	<b>OE</b>	
<b>A</b>	=	<b>L</b>	+	<b>OE</b>		
+3,800		+3,800				
<b>Cash Flows</b> no effect						

	May	4	Merchandise Inventory Accounts Payable (To record goods purchased on account from PW Audio Supply)	3,800 3,800	
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Under the perpetual inventory system, companies record in the Merchandise Inventory account the purchase of goods they intend to sell. Thus, Wal-Mart would increase (debit) Merchandise Inventory for clothing, sporting goods, and anything else purchased for resale to customers.

Not all purchases are debited to Merchandise Inventory, however. Companies record purchases of assets acquired for use and not for resale, such as supplies, equipment, and similar items, as increases to specific asset accounts rather than to Merchandise Inventory. For example, to record the purchase of materials used to

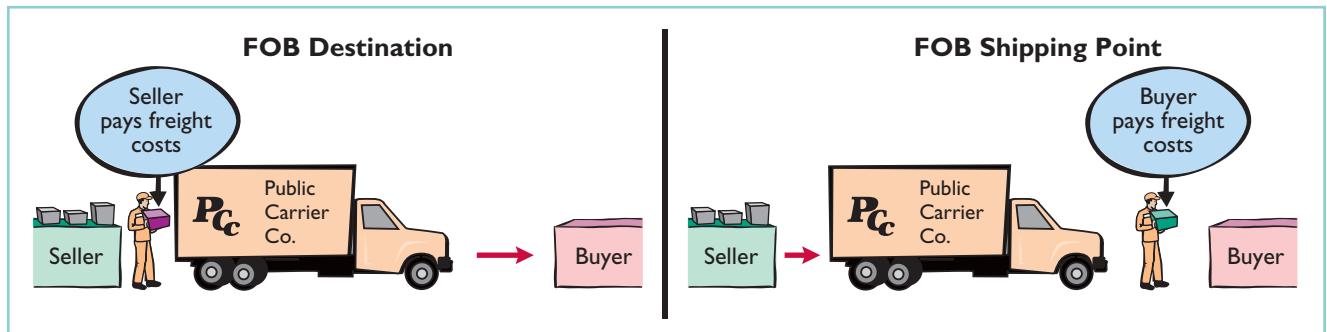
make shelf signs or for cash register receipt paper, Wal-Mart would increase Supplies.

## Freight Costs

The sales agreement should indicate who—the seller or the buyer—is to pay for transporting the goods to the buyer’s place of business. When a common carrier such as a railroad, trucking company, or airline transports the goods, the carrier prepares a freight bill in accord with the sales agreement.

Freight terms are expressed as either FOB shipping point or FOB destination. The letters FOB mean **free on board**. Thus, **FOB shipping point** means that the seller places the goods free on board the carrier, and the buyer pays the freight costs. Conversely, **FOB destination** means that the seller places the goods free on board to the buyer’s place of business, and the seller pays the freight. For example, the sales invoice in Illustration 5-5 indicates FOB shipping point. Thus, the buyer (Sauk Stereo) pays the freight charges. Illustration 5-6 illustrates these shipping terms.

Illustration 5-6  
Shipping terms



When the purchaser incurs the freight costs, it debits (increases) the account Merchandise Inventory for those costs. For example, if upon delivery of the goods on May 6, Sauk Stereo pays Acme Freight Company \$150 for freight charges, the entry on Sauk Stereo’s books is:

May 6	Merchandise Inventory	150	
	Cash		150
	(To record payment of freight on goods purchased)		

A	=	L	+	OE
+150				
-150				
<b>Cash Flows</b>				
-150				

Thus, any freight costs incurred by the buyer are part of the cost of merchandise purchased. The reason: Inventory cost should include any freight charges necessary to deliver the goods to the buyer.

In contrast, **freight costs incurred by the seller on outgoing merchandise are an operating expense to the seller**. These costs increase an expense account titled Freight-out or Delivery Expense. If the freight terms on the invoice in Illustration 5-5 had required PW Audio Supply to pay the freight charges, the entry by PW Audio Supply would have been:

May 4	Freight-out (or Delivery Expense)	150	
	Cash		150
	(To record payment of freight on goods sold)		

A	=	L	+	OE
				-150 Exp
-150				
<b>Cash Flows</b>				
-150				

When the seller pays the freight charges, it will usually establish a higher invoice price for the goods to cover the shipping expense.



## Purchase Returns and Allowances

A purchaser may be dissatisfied with the merchandise received because the goods are damaged or defective, of inferior quality, or do not meet the purchaser's specifications. In such cases, the purchaser may return the goods to the seller for credit if the sale was made on credit, or for a cash refund if the purchase was for cash. This transaction is known as a **purchase return**. Alternatively, the purchaser may choose to keep the merchandise if the seller is willing to grant an allowance (deduction) from the purchase price. This transaction is known as a **purchase allowance**.

Assume that on May 8 Sauk Stereo returned to PW Audio Supply goods costing \$300. The following entry by Sauk Stereo for the returned merchandise decreases (debits) Accounts Payable and decreases (credits) Merchandise Inventory.

A	=	L	+	OE
-300		-300		
<b>Cash Flows</b>				
no effect				

May 8	Accounts Payable	300	
	Merchandise Inventory		300
	(To record return of goods purchased from PW Audio Supply)		

Because Sauk Stereo increased Merchandise Inventory when the goods were received, Merchandise Inventory is decreased when Sauk returns the goods (or when it is granted an allowance).

## Purchase Discounts

The credit terms of a purchase on account may permit the buyer to claim a cash discount for prompt payment. The buyer calls this cash discount a **purchase discount**. This incentive offers advantages to both parties: The purchaser saves money, and the seller shortens the operating cycle by more quickly converting the accounts receivable into cash.

**Credit terms** specify the amount of the cash discount and time period in which it is offered. They also indicate the time period in which the purchaser is expected to pay the full invoice price. In the sales invoice in Illustration 5-5 (page 204) credit terms are 2/10, n/30, which is read “two-ten, net thirty.” This means that the buyer may take a 2% cash discount on the invoice price less (“net of”) any returns or allowances, if payment is made within 10 days of the invoice date (the **discount period**). If the buyer does not pay in that time, the invoice price, less any returns or allowances, is due 30 days from the invoice date.

Alternatively, the discount period may extend to a specified number of days following the month in which the sale occurs. For example, 1/10 EOM (end of month) means that a 1% discount is available if the invoice is paid within the first 10 days of the next month.

When the seller elects not to offer a cash discount for prompt payment, credit terms will specify only the maximum time period for paying the balance due. For example, the invoice may state the time period as n/30, n/60, or n/10 EOM. This means, respectively, that the buyer must pay the net amount in 30 days, 60 days, or within the first 10 days of the next month.

When the buyer pays an invoice within the discount period, the amount of the discount decreases Merchandise Inventory. Why? Because companies record inventory at cost and, by paying within the discount period, the merchandiser has reduced that cost. To illustrate, assume Sauk Stereo pays the balance due of \$3,500 (gross invoice price of \$3,800 less purchase returns and allowances of \$300) on May 14, the last day of the discount period. The cash discount is \$70 ( $\$3,500 \times 2\%$ ), and Sauk Stereo pays \$3,430 ( $\$3,500 - \$70$ ). The entry Sauk makes to record its May 14

### HELPFUL HINT

The term *net* in “net 30” means the remaining amount due after subtracting any sales returns and allowances and partial payments.

payment decreases (debits) Accounts Payable by the amount of the gross invoice price, reduces (credits) Merchandise Inventory by the \$70 discount, and reduces (credits) Cash by the net amount owed.

May 14	Accounts Payable Cash Merchandise Inventory (To record payment within discount period)	3,500  3,430 70	3,430 70
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A	=	L	+	OE
		-3,500		
		-3,430		
		-70		
<hr/>				
Cash Flows				
		-3,430		

If Sauk Stereo failed to take the discount, and instead made full payment of \$3,500 on June 3, it would debit Accounts Payable and credit Cash for \$3,500 each.

June 3	Accounts Payable Cash (To record payment with no discount taken)	3,500	3,500
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A	=	L	+	OE
		-3,500		
		-3,500		
<hr/>				
Cash Flows				
		-3,500		

As a rule, a company usually should take all available discounts. Passing up the discount may be viewed as **paying interest** for use of the money. For example, passing up the discount offered by PW Audio would be comparable to Sauk Stereo paying an interest rate of 2% for the use of \$3,500 for 20 days. This is the equivalent of an annual interest rate of approximately 36.5% ( $2\% \times 365/20$ ). Obviously, it would be better for Sauk Stereo to borrow at prevailing bank interest rates of 6% to 10% than to lose the discount.

## Summary of Purchasing Transactions

The following T account (with transaction descriptions in blue) provides a summary of the effect of the previous transactions on Merchandise Inventory. Sauk originally purchased \$3,800 worth of inventory for resale. It then returned \$300 of goods. It paid \$150 in freight charges, and finally, it received a \$70 discount off the balance owed because it paid within the discount period. This results in a balance in Merchandise Inventory of \$3,580.

Merchandise Inventory				
	Purchase	May 4 3,800	May 8 300	Purchase return
	Freight-in	6 150	14 70	Purchase discount
	Balance	3,580		

### DO IT!

On September 5, De La Hoya Company buys merchandise on account from Junot Diaz Company. The selling price of the goods is \$1,500, and the cost to Diaz Company was \$800. On September 8, De La Hoya returns defective goods with a selling price of \$200 and a scrap value of \$80. Record the transactions on the books of De La Hoya Company.

#### PURCHASE TRANSACTIONS

**action plan**

- ✓ Purchaser records goods at cost.
- ✓ When goods are returned, purchaser reduces Merchandise Inventory.

**Solution**

Sept.	5	Merchandise Inventory Accounts Payable (To record goods purchased on account)	1,500		1,500
	8	Accounts Payable Merchandise Inventory (To record return of defective goods)	200		200

Related exercise material: BE5-2, BE5-4, E5-2, E5-3, E5-4, and **DO IT!** 5-1.



**RECORDING SALES OF MERCHANDISE**

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

Companies record sales revenues, like service revenues, when earned, in compliance with the revenue recognition principle. Typically, companies earn sales revenues when the goods transfer from the seller to the buyer. At this point the sales transaction is complete and the sales price established.

Sales may be made on credit or for cash. A **business document** should support every sales transaction, to provide written evidence of the sale. **Cash register tapes** provide evidence of cash sales. A **sales invoice**, like the one shown in Illustration 5-5 (page 204), provides support for a credit sale. The original copy of the invoice goes to the customer, and the seller keeps a copy for use in recording the sale. The invoice shows the date of sale, customer name, total sales price, and other relevant information.

The seller makes two entries for each sale. The first entry records the sale: The seller increases (debits) Cash (or Accounts Receivable, if a credit sale), and also increases (credits) Sales for the invoice price of the goods. The second entry records the cost of the merchandise sold: The seller increases (debits) Cost of Goods Sold, and also decreases (credits) Merchandise Inventory for the cost of those goods. As a result, the Merchandise Inventory account will show at all times the amount of inventory that should be on hand.

To illustrate a credit sales transaction, PW Audio Supply records its May 4 sale of \$3,800 to Sauk Stereo (see Illustration 5-5) as follows. (Here, we assume the merchandise cost PW Audio Supply \$2,400.)

A	=	L	+	OE
+3,800				+3,800 Rev
<b>Cash Flows</b>				
no effect				

May	4	Accounts Receivable Sales (To record credit sale to Sauk Stereo per invoice #731)	3,800		3,800
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A	=	L	+	OE
-2,400				-2,400 Exp
<b>Cash Flows</b>				
no effect				

4		Cost of Goods Sold Merchandise Inventory (To record cost of merchandise sold on invoice #731 to Sauk Stereo)	2,400		2,400
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For internal decision-making purposes, merchandising companies may use more than one sales account. For example, PW Audio Supply may decide to keep

separate sales accounts for its sales of TV sets, DVD recorders, and satellite radio receivers. **Wal-Mart** might use separate accounts for sporting goods, children’s clothing, and hardware—or it might have even more narrowly defined accounts. By using separate sales accounts for major product lines, rather than a single combined sales account, company management can more closely monitor sales trends and respond more strategically to changes in sales patterns. For example, if HDTV sales are increasing while DVD-player sales are decreasing, PW Audio Supply might reevaluate both its advertising and pricing policies on these items to ensure they are optimal.

On its income statement presented to outside investors, a merchandising company normally would provide only a single sales figure—the sum of all of its individual sales accounts. This is done for two reasons. First, providing detail on all of its individual sales accounts would add considerable length to its income statement. Second, companies do not want their competitors to know the details of their operating results. However, **Microsoft** recently expanded its disclosure of revenue from three to five types. The reason: The additional categories will better enable financial statement users to evaluate the growth of the company’s consumer and Internet businesses.



**ETHICS NOTE**

Many companies are trying to improve the quality of their financial reporting. For example, **General Electric** now provides more detail on its revenues and operating profits.

### Sales Returns and Allowances

We now look at the “flipside” of purchase returns and allowances, which the seller records as **sales returns and allowances**. PW Audio Supply’s entries to record credit for returned goods involve (1) an increase in Sales Returns and Allowances and a decrease in Accounts Receivable at the \$300 selling price, and (2) an increase in Merchandise Inventory (assume a \$140 cost) and a decrease in Cost of Goods Sold as shown below (assuming that the goods were not defective).

	May 8	Sales Returns and Allowances	300		
		Accounts Receivable		300	
		(To record credit granted to Sauk Stereo for returned goods)			
	8	Merchandise Inventory	140		
		Cost of Goods Sold		140	
		(To record cost of goods returned)			

A	=	L	+	OE	
					-300 Rev
					-300
<hr/>					
<b>Cash Flows</b>					
no effect					
<hr/>					
A	=	L	+	OE	
					+140
					+140 Exp
<hr/>					
<b>Cash Flows</b>					
no effect					

If Sauk returns goods because they are damaged or defective, then PW Audio Supply’s entry to Merchandise Inventory and Cost of Goods Sold should be for the estimated value of the returned goods, rather than their cost. For example, if the returned goods were defective and had a scrap value of \$50, PW Audio would debit Merchandise Inventory for \$50, and would credit Cost of Goods Sold for \$50.

Sales Returns and Allowances is a **contra-revenue account** to Sales. The normal balance of Sales Returns and Allowances is a debit. Companies use a contra account, instead of debiting Sales, to disclose in the accounts and in the income statement the amount of sales returns and allowances. Disclosure of this information is important to management: Excessive returns and allowances may suggest problems—inferior merchandise, inefficiencies in filling orders, errors in billing customers, or delivery or shipment mistakes. Moreover, a decrease (debit) recorded directly to Sales would obscure the relative importance of sales returns and allowances as a percentage of sales. It also could distort comparisons between total sales in different accounting periods.

## ACCOUNTING ACROSS THE ORGANIZATION



### Should Publishers Have Liberal Return Policies?

In most industries sales returns are relatively minor. In the publishing industry, however, bookstores are allowed to return unsold hardcover books to the publisher. Marketing managers at the publishing companies argue that these generous return policies are necessary to encourage bookstores to buy a broader range of books, instead of focusing just on “sure things.”

But with returns of hardcover books now exceeding 34% of sales, this generous return policy is taking its toll on net income. Production and inventory managers are quick to point out the many costs of excess returns. Publishers must pay to have the books shipped back to their warehouse, sorted, and then shipped to discounters. If the discounters don't sell them, the books are repackaged again, shipped back to the publisher, and destroyed. Some bookstores and publishers have proposed adopting a “no returns” policy, but no company wants to be the first to implement it.

**Source:** Jeffrey A Trachtenberg, “Quest for Best Seller Creates a Pileup of Returned Books,” *Wall Street Journal* (June 3, 2005), p. A1.



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

## Sales Discounts

As mentioned earlier, the seller may offer the customer a cash discount—called by the seller a **sales discount**—for the prompt payment of the balance due. It is based on the invoice price less returns and allowances, if any. The seller increases (debits) the Sales Discounts account for discounts that are taken. For example, PW Audio Supply makes the following entry to record the cash receipt on May 14 from Sauk Stereo within the discount period.

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+3,430				-70 Rev
-3,500				
<b>Cash Flows</b>				
+3,430				



May 14	Cash	3,430	
	Sales Discounts	70	
	Accounts Receivable		3,500
	(To record collection within 2/10, n/30 discount period from Sauk Stereo)		

Like Sales Returns and Allowances, Sales Discounts is a **contra-revenue account** to Sales. Its normal balance is a debit. PW Audio uses this account, instead of debiting sales, to disclose the amount of cash discounts taken by customers. If Sauk Stereo does not take the discount, PW Audio Supply increases Cash for \$3,500 and decreases Accounts Receivable for the same amount at the date of collection.

## DO IT!

### SALES TRANSACTIONS

Assume information similar to that in the Do It! on page 207. That is: On September 5, De La Hoya Company buys merchandise on account from Junot Diaz Company. The selling price of the goods is \$1,500, and the cost to Diaz

Company was \$800. On September 8, De La Hoya returns defective goods with a selling price of \$200 and a scrap value of \$80. Record the transactions on the books of Junot Diaz Company.

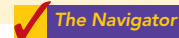
**Solution**

Sept.	5	Accounts Receivable	1,500	
		Sales		1,500
		(To record credit sale)		
	5	Cost of Goods Sold	800	
		Merchandise Inventory		800
		(To record cost of goods sold on account)		
Sept.	8	Sales Returns and Allowances	200	
		Accounts Receivable		200
		(To record credit granted for receipt of returned goods)		
	8	Merchandise Inventory	80	
		Cost of Goods Sold		80
		(To record scrap value of goods returned)		

**action plan**

- ✓ Seller records both the sale and the cost of goods sold at the time of the sale.
- ✓ When goods are returned, the seller records the return in a contra account, Sales Returns and Allowances, and reduces Accounts Receivable. Any goods returned increase Merchandise Inventory and reduce Cost of Goods Sold.
- ✓ Record merchandise inventory at its market value (scrap value).

Related exercise material: BE5-2, BE5-3, E5-3, E5-4, E5-5, and **DO IT!** 5-2.



## COMPLETING THE ACCOUNTING CYCLE

Up to this point, we have illustrated the basic entries for transactions relating to purchases and sales in a perpetual inventory system. Now we consider the remaining steps in the accounting cycle for a merchandising company. Each of the required steps described in Chapter 4 for service companies apply to merchandising companies. Appendix 5B to this chapter shows use of a worksheet by a merchandiser (an optional step).

### STUDY OBJECTIVE 4

Explain the steps in the accounting cycle for a merchandising company.

## Adjusting Entries

A merchandising company generally has the same types of adjusting entries as a service company. However, a merchandiser using a perpetual system will require one additional adjustment to make the records agree with the actual inventory on hand. Here's why: At the end of each period, for control purposes, a merchandising company that uses a perpetual system will take a physical count of its goods on hand. The company's unadjusted balance in Merchandise Inventory usually does not agree with the actual amount of inventory on hand. The perpetual inventory records may be incorrect due to recording errors, theft, or waste. Thus, the company needs to adjust the perpetual records to make the recorded inventory amount agree with the inventory on hand. **This involves adjusting Merchandise Inventory and Cost of Goods Sold.**

For example, suppose that PW Audio Supply has an unadjusted balance of \$40,500 in Merchandise Inventory. Through a physical count, PW Audio determines



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that its actual merchandise inventory at year-end is \$40,000. The company would make an adjusting entry as follows.

Cost of Goods Sold	500	
Merchandise Inventory		500
(To adjust inventory to physical count)		

### Closing Entries

A merchandising company, like a service company, closes to Income Summary all accounts that affect net income. In journalizing, the company credits all temporary accounts with debit balances, and debits all temporary accounts with credit balances, as shown below for PW Audio Supply. Note that PW Audio closes Cost of Goods Sold to Income Summary.

#### HELPFUL HINT

The easiest way to prepare the first two closing entries is to identify the temporary accounts by their balances and then prepare one entry for the credits and one for the debits.

Dec. 31	Sales	480,000	
	Income Summary		480,000
	(To close income statement accounts with credit balances)		
31	Income Summary	450,000	
	Sales Returns and Allowances		12,000
	Sales Discounts		8,000
	Cost of Goods Sold		316,000
	Store Salaries Expense		45,000
	Administrative Salaries Expense		19,000
	Freight-out		7,000
	Advertising Expense		16,000
	Utilities Expense		17,000
	Depreciation Expense		8,000
	Insurance Expense		2,000
	(To close income statement accounts with debit balances)		
31	Income Summary	30,000	
	R.A. Lamb, Capital		30,000
	(To close net income to capital)		
31	R.A. Lamb, Capital	15,000	
	R.A. Lamb, Drawing		15,000
	(To close drawings to capital)		

After PW Audio has posted the closing entries, all temporary accounts have zero balances. Also, R.A. Lamb, Capital has a balance that is carried over to the next period.

### Summary of Merchandising Entries

Illustration 5-7 summarizes the entries for the merchandising accounts using a perpetual inventory system.

	<u>Transactions</u>	<u>Daily Recurring Entries</u>	<u>Dr.</u>	<u>Cr.</u>
<b>Sales Transactions</b>	Selling merchandise to customers.	Cash or Accounts Receivable	XX	
		Sales		XX
		Cost of Goods Sold Merchandise Inventory	XX	XX
	Granting sales returns or allowances to customers.	Sales Returns and Allowances	XX	
		Cash or Accounts Receivable		XX
Merchandise Inventory Cost of Goods Sold		XX	XX	
Paying freight costs on sales; FOB destination.	Freight-out Cash	XX	XX	
Receiving payment from customers within discount period.	Cash Sales Discounts Accounts Receivable	XX XX	XX	
<b>Purchase Transactions</b>	Purchasing merchandise for resale.	Merchandise Inventory	XX	
		Cash or Accounts Payable		XX
	Paying freight costs on merchandise purchased; FOB shipping point.	Merchandise Inventory	XX	
		Cash		XX
	Receiving purchase returns or allowances from suppliers.	Cash or Accounts Payable Merchandise Inventory	XX	XX
Paying suppliers within discount period.	Accounts Payable Merchandise Inventory Cash	XX	XX XX	
	<u>Events</u>	<u>Adjusting and Closing Entries</u>		
	Adjust because book amount is higher than the inventory amount determined to be on hand.	Cost of Goods Sold	XX	
		Merchandise Inventory		XX
	Closing temporary accounts with credit balances.	Sales	XX	
		Income Summary		XX
	Closing temporary accounts with debit balances.	Income Summary	XX	
		Sales Returns and Allowances		XX
		Sales Discounts		XX
		Cost of Goods Sold		XX
		Freight-out Expenses		XX XX

**Illustration 5-7**  
Daily recurring and adjusting and closing entries

**DO IT!**

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

**CLOSING ENTRIES**

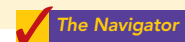
### action plan

- ✓ Close all temporary accounts with credit balances to Income Summary by debiting these accounts.
- ✓ Close all temporary accounts with debit balances, except drawings, to Income Summary by crediting these accounts.

**Solution** The two closing entries are:

Dec. 31	Sales	162,400	
	Rental Revenue	6,000	
	Income Summary		168,400
	(To close accounts with credit balances)		
31	Income Summary	151,000	
	Cost of Goods Sold		110,000
	Sales Returns and Allowances		4,800
	Sales Discounts		3,600
	Freight-out		1,800
	Rent Expense		8,800
	Salaries and Wages Expense		22,000
	(To close accounts with debit balances)		

Related exercise material: BE5-5, BE5-6, E5-6, E5-7, E5-8, and **DO IT!** 5-3.



## FORMS OF FINANCIAL STATEMENTS

### STUDY OBJECTIVE 5

Distinguish between a multiple-step and a single-step income statement.

Merchandising companies widely use the classified balance sheet introduced in Chapter 4 and one of two forms for the income statement. This section explains the use of these financial statements by merchandisers.

### Multiple-Step Income Statement

The **multiple-step income statement** is so named because it shows several steps in determining net income. Two of these steps relate to the company's principal operating activities. A multiple-step statement also distinguishes between **operating** and **non-operating activities**. Finally, the statement also highlights intermediate components of income and shows subgroupings of expenses.

#### INCOME STATEMENT PRESENTATION OF SALES

The multiple-step income statement begins by presenting **sales revenue**. It then deducts contra-revenue accounts—sales returns and allowances, and sales discounts—to arrive at **net sales**. Illustration 5-8 presents the sales revenues section for PW Audio Supply, using assumed data.

**Illustration 5-8**  
Computation of net sales

PW AUDIO SUPPLY			
Income Statement (partial)			
<b>Sales revenues</b>			
Sales			\$480,000
Less: Sales returns and allowances	\$12,000		
Sales discounts	8,000		20,000
<b>Net sales</b>			<b>\$460,000</b>

This presentation discloses the key data about the company's principal revenue-producing activities.

#### GROSS PROFIT

From Illustration 5-1, you learned that companies deduct from sales revenue the cost of goods sold in order to determine **gross profit**. For this computation, companies use

**net sales** as the amount of sales revenue. On the basis of the sales data in Illustration 5-8 (net sales of \$460,000) and cost of goods sold under the perpetual inventory system (assume \$316,000), PW Audio's gross profit is \$144,000, computed as follows.

**STUDY OBJECTIVE 6**

Explain the computation and importance of gross profit.

Net sales	\$460,000
Cost of goods sold	<u>316,000</u>
<b>Gross profit</b>	<b>\$144,000</b>

**Illustration 5-9**

Computation of gross profit

We also can express a company's gross profit as a percentage, called the **gross profit rate**. To do so, we divide the amount of gross profit by net sales. For PW Audio, the **gross profit rate** is 31.3%, computed as follows.

<b>Gross Profit</b>	÷	<b>Net Sales</b>	=	<b>Gross Profit Rate</b>
\$144,000	÷	\$460,000	=	<b>31.3%</b>

**Illustration 5-10**

Gross profit rate formula and computation

Analysts generally consider the gross profit **rate** to be more useful than the gross profit **amount**. The rate expresses a more meaningful (qualitative) relationship between net sales and gross profit. For example, a gross profit of \$1,000,000 may sound impressive. But if it is the result of a gross profit rate of only 7%, it is not so impressive. The gross profit rate tells how many cents of each sales dollar go to gross profit.

Gross profit represents the **merchandising profit** of a company. It is not a measure of the overall profitability, because operating expenses are not yet deducted. But managers and other interested parties closely watch the amount and trend of gross profit. They compare current gross profit with amounts reported in past periods. They also compare the company's gross profit rate with rates of competitors and with industry averages. Such comparisons provide information about the effectiveness of a company's purchasing function and the soundness of its pricing policies.

**OPERATING EXPENSES AND NET INCOME**

**Operating expenses** are the next component in measuring net income for a merchandising company. They are the expenses incurred in the process of earning sales revenue. These expenses are similar in merchandising and service enterprises. At PW Audio, operating expenses were \$114,000. The company determines its net income by subtracting operating expenses from gross profit. Thus, net income is \$30,000, as shown below.

Gross profit	\$144,000
<b>Operating expenses</b>	<u><b>114,000</b></u>
Net income	<u>\$ 30,000</u>

**Illustration 5-11**

Operating expenses in computing net income

The net income amount is the so-called "bottom line" of a company's income statement.

**NONOPERATING ACTIVITIES**

**Nonoperating activities** consist of various revenues and expenses and gains and losses that are unrelated to the company's main line of operations. When nonoperating items are included, the label "**Income from operations**" (or "Operating income") precedes them. This label clearly identifies the results of the company's normal operations, an amount determined by

**ETHICS NOTE**

Companies manage earnings in various ways. **ConAgra Foods** recorded a nonrecurring gain for \$186 million from the sale of **Pilgrim's Pride** stock to help meet an earnings projection for the quarter.

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subtracting cost of goods sold and operating expenses from net sales. The results of nonoperating activities are shown in the categories “**Other revenues and gains**” and “**Other expenses and losses**.” Illustration 5-12 lists examples of each.

**Illustration 5-12**

Other items of nonoperating activities

<b>Other Revenues and Gains</b>	
<b>Interest revenue</b>	from notes receivable and marketable securities.
<b>Dividend revenue</b>	from investments in capital stock.
<b>Rent revenue</b>	from subleasing a portion of the store.
<b>Gain</b>	from the sale of property, plant, and equipment.
<b>Other Expenses and Losses</b>	
<b>Interest expense</b>	on notes and loans payable.
<b>Casualty losses</b>	from recurring causes, such as vandalism and accidents.
<b>Loss</b>	from the sale or abandonment of property, plant, and equipment.
<b>Loss</b>	from strikes by employees and suppliers.

Merchandising companies report the nonoperating activities in the income statement immediately after the company’s primary operating activities. Illustration 5-13 shows these sections for PW Audio Supply, Inc., using assumed data.

**Illustration 5-13**

Multiple-step income statement

<b>PW AUDIO SUPPLY, INC.</b>			
Income Statement			
For the Year Ended December 31, 2010			
<b>Calculation of gross profit</b>	<b>Sales revenues</b>		
	Sales		\$480,000
	Less: Sales returns and allowances	\$12,000	
	Sales discounts	8,000	20,000
	Net sales		460,000
	<b>Cost of goods sold</b>		316,000
	<b>Gross profit</b>		144,000
<b>Calculation of income from operations</b>	<b>Operating expenses</b>		
	Salaries expense	64,000	
	Utilities expense	17,000	
	Advertising expense	16,000	
	Depreciation expense	8,000	
	Freight-out	7,000	
	Insurance expense	2,000	
	Total operating expenses		114,000
	<b>Income from operations</b>		30,000
<b>Results of nonoperating activities</b>	<b>Other revenues and gains</b>		
	Interest revenue	3,000	
	Gain on sale of equipment	600	
		3,600	
	<b>Other expenses and losses</b>		
Interest expense	1,800		
Casualty loss from vandalism	200		
	2,000		
			1,600
	<b>Net income</b>		<b>\$ 31,600</b>

The distinction between operating and nonoperating activities is crucial to many external users of financial data. These users view operating income as sustainable and many nonoperating activities as nonrecurring. Therefore, when forecasting next year's income, analysts put the most weight on this year's operating income, and less weight on this year's nonoperating activities.

## Single-Step Income Statement

Another income statement format is the **single-step income statement**. The statement is so named because only one step—subtracting total expenses from total revenues—is required in determining net income.

In a single-step statement, all data are classified into two categories: (1) **revenues**, which include both operating revenues and other revenues and gains; and (2) **expenses**, which include cost of goods sold, operating expenses, and other expenses and losses. Illustration 5-14 shows a single-step statement for PW Audio Supply.

PW AUDIO SUPPLY		
Income Statement		
For the Year Ended December 31, 2010		
<b>Revenues</b>		
Net sales		\$460,000
Interest revenue		3,000
Gain on sale of equipment		600
Total revenues		<u>463,600</u>
<b>Expenses</b>		
Cost of goods sold	\$316,000	
Operating expenses	114,000	
Interest expense	1,800	
Casualty loss from vandalism	<u>200</u>	
Total expenses		<u>432,000</u>
<b>Net income</b>		<u>\$ 31,600</u>

**Illustration 5-14**  
Single-step income statement

There are two primary reasons for using the single-step format: (1) A company does not realize any type of profit or income until total revenues exceed total expenses, so it makes sense to divide the statement into these two categories. (2) The format is simpler and easier to read. *For homework problems, however, you should use the single-step format only when specifically instructed to do so.*

## Classified Balance Sheet

In the balance sheet, merchandising companies report merchandise inventory as a current asset immediately below accounts receivable. Recall from Chapter 4 that companies generally list current asset items in the order of their closeness to cash (liquidity). Merchandise inventory is less close to cash than accounts receivable, because the goods must first be sold and then collection made from the customer. Illustration 5-15 (page 218) presents the assets section of a classified balance sheet for PW Audio Supply.



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Illustration 5-15

Assets section of a classified balance sheet

PW AUDIO SUPPLY		
Balance Sheet (Partial) December 31, 2010		
<u>Assets</u>		
Current assets		
Cash		\$ 9,500
Accounts receivable		16,100
<b>Merchandise inventory</b>		40,000
Prepaid insurance		1,800
Total current assets		67,400
Property, plant, and equipment		
Store equipment	\$80,000	
Less: Accumulated depreciation—store equipment	24,000	56,000
Total assets		\$123,400

**HELPFUL HINT**

The \$40,000 is the cost of the inventory on hand, not its expected selling price.

**DO IT!**

**FINANCIAL STATEMENT CLASSIFICATIONS**

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

- |  |                                |
|--|--------------------------------|
| Accounts Payable                         | Interest Payable               |
| Accounts Receivable                      | Land                           |
| Accumulated Depreciation—Office Building | Merchandise Inventory          |
| Accumulated Depreciation—Store Equipment | Notes Payable (due in 3 years) |
| Advertising Expense                      | Office Building                |
| Depreciation Expense                     | Property Tax Payable           |
| B. Gorman, Capital                       | Salaries Expense               |
| B. Gorman, Drawing                       | Salaries Payable               |
| Cash                                     | Sales Returns and Allowances   |
| Freight-out                              | Store Equipment                |
| Gain on Sale of Equipment                | Sales Revenue                  |
| Insurance Expense                        | Utilities Expense              |
| Interest Expense                         |                                |

**action plan**

- ✓ Review the major sections of the income statement, sales revenues, cost of goods sold, operating expenses, other revenues and gains, and other expenses and losses.
- ✓ Add net income and investments to beginning capital and deduct drawings to arrive at ending capital in the statement of owner's equity.
- ✓ Review the major sections of the balance sheet, income statement, and statement of owner's equity.

**Solution**

<u>Account</u>	<u>Financial Statement</u>	<u>Classification</u>
Accounts Payable	Balance sheet	Current liabilities
Accounts Receivable	Balance sheet	Current assets
Accumulated Depreciation—Office Building	Balance sheet	Property, plant, and equipment
Accumulated Depreciation—Store Equipment	Balance sheet	Property, plant, and equipment
Advertising Expense	Income statement	Operating expenses
Depreciation Expense	Income statement	Operating expenses

B. Gorman, Capital	Statement of owner's equity	Beginning balance
B. Gorman, Drawing	Statement of owner's equity	Deduction section
Cash	Balance sheet	Current assets
Freight-out	Income statement	Operating expenses
Gain on Sale of Equipment	Income statement	Other revenues and gains
Insurance Expense	Income statement	Operating expenses
Interest Expense	Income statement	Other expenses and losses
Interest Payable	Balance sheet	Current liabilities
Land	Balance sheet	Property, plant, and equipment
Merchandise Inventory	Balance sheet	Current assets
Notes Payable	Balance sheet	Long-term liabilities
Office Building	Balance sheet	Property, plant, and equipment
Property Tax Payable	Balance sheet	Current liabilities
Salaries Expense	Income statement	Operating expenses
Salaries Payable	Balance sheet	Current liabilities
Sales Returns and Allowances	Income statement	Sales revenues
Store Equipment	Balance sheet	Property, plant, and equipment
Sales Revenue	Income statement	Sales revenues
Utilities Expense	Income statement	Operating expenses

Related exercise material: BE5-7, BE5-8, BE5-9, E5-9, E5-10, E5-12, E5-13, E5-14, and **DO IT!** 5-4.



## Comprehensive DO IT!



The adjusted trial balance columns of Falcetto Company's worksheet for the year ended December 31, 2010, are as follows.

Debit		Credit	
Cash	14,500	Accumulated Depreciation	18,000
Accounts Receivable	11,100	Notes Payable	25,000
Merchandise Inventory	29,000	Accounts Payable	10,600
Prepaid Insurance	2,500	Larry Falcetto, Capital	81,000
Store Equipment	95,000	Sales	536,800
Larry Falcetto, Drawing	12,000	Interest Revenue	2,500
Sales Returns and Allowances	6,700		<u>673,900</u>
Sales Discounts	5,000		
Cost of Goods Sold	363,400		
Freight-out	7,600		
Advertising Expense	12,000		
Salaries Expense	56,000		
Utilities Expense	18,000		
Rent Expense	24,000		
Depreciation Expense	9,000		
Insurance Expense	4,500		
Interest Expense	3,600		
	<u>673,900</u>		

**220 Chapter 5 Accounting for Merchandising Operations****action plan**

- ✓ Remember that the key components of the income statement are net sales, cost of goods sold, gross profit, total operating expenses, and net income (loss). Report these components in the right-hand column of the income statement.
- ✓ Put nonoperating items after income from operations.

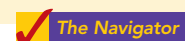
**Instructions**

Prepare a multiple-step income statement for Falcetto Company.

**Solution to Comprehensive DO IT!**

**FALCETTO COMPANY**  
Income Statement  
For the Year Ended December 31, 2010

Sales revenues		
Sales		\$536,800
Less: Sales returns and allowances	\$6,700	
Sales discounts	5,000	11,700
Net sales		525,100
Cost of goods sold		363,400
Gross profit		161,700
Operating expenses		
Salaries expense	56,000	
Rent expense	24,000	
Utilities expense	18,000	
Advertising expense	12,000	
Depreciation expense	9,000	
Freight-out	7,600	
Insurance expense	4,500	
Total operating expenses		131,100
Income from operations		30,600
Other revenues and gains		
Interest revenue	2,500	
Other expenses and losses		
Interest expense	3,600	1,100
Net income		\$ 29,500

**SUMMARY OF STUDY OBJECTIVES**

- 1 Identify the differences between service and merchandising companies.** Because of inventory, a merchandising company has sales revenue, cost of goods sold, and gross profit. To account for inventory, a merchandising company must choose between a perpetual and a periodic inventory system.
- 2 Explain the recording of purchases under a perpetual inventory system.** The company debits the Merchandise Inventory account for all purchases of merchandise and freight-in, and credits it for purchase discounts and purchase returns and allowances.
- 3 Explain the recording of sales revenues under a perpetual inventory system.** When a merchandising company sells inventory, it debits Accounts Receivable (or Cash), and credits Sales for the **selling price** of the merchandise. At the same time, it debits Cost of Goods Sold, and credits Merchandise Inventory for the **cost** of the inventory items sold.
- 4 Explain the steps in the accounting cycle for a merchandising company.** Each of the required steps in the

accounting cycle for a service company applies to a merchandising company. A worksheet is again an optional step. Under a perpetual inventory system, the company must adjust the Merchandise Inventory account to agree with the physical count.

- 5 Distinguish between a multiple-step and a single-step income statement.** A multiple-step income statement shows numerous steps in determining net income, including nonoperating activities sections. A single-step income statement classifies all data under two categories, revenues or expenses, and determines net income in one step.
- 6 Explain the computation and importance of gross profit.** Merchandising companies compute gross profit by subtracting cost of goods sold from net sales. Gross profit represents the merchandising profit of a company. Managers and other interested parties closely watch the amount and trend of gross profit and of the gross profit rate.



## GLOSSARY



- Contra-revenue account** An account that is offset against a revenue account on the income statement. (p. 209).
- Cost of goods sold** The total cost of merchandise sold during the period. (p. 200).
- FOB destination** Freight terms indicating that the seller places the goods free on board to the buyer's place of business, and the seller pays the freight. (p. 205).
- FOB shipping point** Freight terms indicating that the seller places goods free on board the carrier, and the buyer pays the freight costs. (p. 205).
- Gross profit** The excess of net sales over the cost of goods sold. (p. 214).
- Gross profit rate** Gross profit expressed as a percentage, by dividing the amount of gross profit by net sales. (p. 215).
- Income from operations** Income from a company's principal operating activity; determined by subtracting cost of goods sold and operating expenses from net sales. (p. 215).
- Multiple-step income statement** An income statement that shows several steps in determining net income. (p. 214).
- Net sales** Sales less sales returns and allowances and less sales discounts. (p. 214).
- Nonoperating activities** Various revenues, expenses, gains, and losses that are unrelated to a company's main line of operations. (p. 215).
- Operating expenses** Expenses incurred in the process of earning sales revenues. (p. 215).
- Other expenses and losses** A nonoperating-activities section of the income statement that shows expenses and losses unrelated to the company's main line of operations. (p. 216).
- Other revenues and gains** A nonoperating-activities section of the income statement that shows revenues and gains unrelated to the company's main line of operations. (p. 216).
- Periodic inventory system** An inventory system under which the company does not keep detailed inventory records throughout the accounting period but determines the cost of goods sold only at the end of an accounting period. (p. 202).
- Perpetual inventory system** An inventory system under which the company keeps detailed records of the cost of each inventory purchase and sale and the records continuously show the inventory that should be on hand. (p. 201).
- Purchase allowance** A deduction made to the selling price of merchandise, granted by the seller so that the buyer will keep the merchandise. (p. 206).
- Purchase discount** A cash discount claimed by a buyer for prompt payment of a balance due. (p. 206).
- Purchase invoice** A document that supports each credit purchase. (p. 203).
- Purchase return** A return of goods from the buyer to the seller for a cash or credit refund. (p. 206).
- Sales discount** A reduction given by a seller for prompt payment of a credit sale. (p. 210).
- Sales invoice** A document that supports each credit sale. (p. 208).
- Sales returns and allowances** Purchase returns and allowances from the seller's perspective. See *Purchase return* and *Purchase allowance*, above. (p. 209).
- Sales revenue (Sales)** The primary source of revenue in a merchandising company. (p. 200).
- Single-step income statement** An income statement that shows only one step in determining net income. (p. 217).

## APPENDIX 5A Periodic Inventory System

As described in this chapter, companies may use one of two basic systems of accounting for inventories: (1) the perpetual inventory system or (2) the periodic inventory system. In the chapter we focused on the characteristics of the perpetual inventory system. In this appendix we discuss and illustrate the **periodic inventory system**. One key difference between the two systems is the point at which the company computes cost of goods sold. For a visual reminder of this difference, refer back to Illustration 5-4 on page 202.

### STUDY OBJECTIVE 7

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

### Determining Cost of Goods Sold Under a Periodic System

When a company uses a perpetual inventory system, it records all transactions affecting inventory (such as purchases, freight costs, returns, and discounts) directly to the Merchandise Inventory account. In addition, at the time of each sale the perpetual

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system requires a reduction in Merchandise Inventory and an increase in Cost of Goods Sold.

Under a periodic system, however, the company uses **separate accounts** to record purchases, freight costs, returns, and discounts. Also, the company does not maintain a running account of changes in inventory. Instead, at the end of the period, it calculates the balance in ending inventory, as well as the cost of goods sold for the period. Illustration 5A-1 shows the calculation of cost of goods sold for PW Audio Supply, using a periodic inventory system. Note that it includes (here, in blue type) separate amounts for beginning inventory, cost of goods purchased, and ending inventory. These are the inputs to the cost of goods sold computation under a periodic system.

**Illustration 5A-1**

Cost of goods sold for a merchandising company using a periodic inventory system

**HELPFUL HINT**

Reading from right to left, the second column identifies the primary items that make up cost of goods sold of \$316,000. The third column explains cost of goods purchased of \$320,000. The fourth column reports contra-purchase items of \$17,200.

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

A company reports merchandise inventory in the current assets section whether it uses a periodic or a perpetual system.

**Recording Merchandise Transactions**

In a **periodic inventory system**, companies record revenues from the sale of merchandise when sales are made, just as in a perpetual system. Unlike the perpetual system, however, companies **do not attempt on the date of sale to record the cost of the merchandise sold**. Instead, they take a physical inventory count at the **end of the period** to determine (1) the cost of the merchandise then on hand and (2) the cost of the goods sold during the period. And, **under a periodic system, companies record purchases of merchandise in the Purchases account rather than the Merchandise Inventory account**. Also, in a periodic system, purchase returns and allowances, purchase discounts, and freight costs on purchases are recorded in separate accounts.

To illustrate the recording of merchandise transactions under a periodic inventory system, we will use purchase/sale transactions between PW Audio Supply, Inc. and Sauk Stereo, as illustrated for the perpetual inventory system in this chapter.

**Recording Purchases of Merchandise**

On the basis of the sales invoice (Illustration 5-5, shown on page 204) and receipt of the merchandise ordered from PW Audio Supply, Sauk Stereo records the \$3,800 purchase as follows.

May 4	Purchases	3,800	
	Accounts Payable		3,800
	(To record goods purchased on account from PW Audio Supply)		

Purchases is a temporary account whose normal balance is a debit.

**HELPFUL HINT**

Be careful not to debit purchases of equipment or supplies to a Purchases account.

**FREIGHT COSTS**

When the purchaser directly incurs the freight costs, it debits the account Freight-in (or Transportation-in). For example, if Sauk pays Acme Freight Company \$150 for freight charges on its purchase from PW Audio Supply on May 6, the entry on Sauk's books is:

May 6	Freight-in (Transportation-in)	150	
	Cash		150
	(To record payment of freight on goods purchased)		

Like Purchases, Freight-in is a temporary account whose normal balance is a debit. **Freight-in is part of cost of goods purchased.** The reason is that cost of goods purchased should include any freight charges necessary to bring the goods to the purchaser. Freight costs are not subject to a purchase discount. Purchase discounts apply only to the invoice cost of the merchandise.

**ALTERNATIVE TERMINOLOGY**

Freight-in is also called *transportation-in*.

**PURCHASE RETURNS AND ALLOWANCES**

Sauk Stereo returns \$300 of goods to PW Audio Supply and prepares the following entry to recognize the return.

May 8	Accounts Payable	300	
	Purchase Returns and Allowances		300
	(To record return of goods purchased from PW Audio Supply)		

Purchase Returns and Allowances is a temporary account whose normal balance is a credit.

**PURCHASE DISCOUNTS**

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

May 14	Accounts Payable (\$3,800 – \$300)	3,500	
	Purchase Discounts ( $\$3,500 \times .02$ )		70
	Cash		3,430
	(To record payment within the discount period)		

Purchase Discounts is a temporary account whose normal balance is a credit.

**Recording Sales of Merchandise**

The seller, PW Audio Supply, records the sale of \$3,800 of merchandise to Sauk Stereo on May 4 (sales invoice No. 731, Illustration 5-5, page 204) as follows.

May 4	Accounts Receivable	3,800	
	Sales		3,800
	(To record credit sales per invoice #731 to Sauk Stereo)		

**SALES RETURNS AND ALLOWANCES**

To record the returned goods received from Sauk Stereo on May 8, PW Audio Supply records the \$300 sales return as follows.

May 8	Sales Returns and Allowances	300	
	Accounts Receivable		300
	(To record credit granted to Sauk Stereo for returned goods)		



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**SALES DISCOUNTS**

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

May 14	Cash	3,430	
	Sales Discounts ( $\$3,500 \times .02$ )	70	
	Accounts Receivable ( $\$3,800 - \$300$ )		3,500
	(To record collection within 2/10, n/30 discount period from Sauk Stereo)		

**COMPARISON OF ENTRIES—PERPETUAL VS. PERIODIC**

Illustration 5A-2 summarizes the periodic inventory entries shown in this appendix and compares them to the perpetual-system entries from the chapter. Entries that differ in the two systems are shown in color.

**Illustration 5A-2**

Comparison of entries for perpetual and periodic inventory systems

ENTRIES ON SAUK STEREO'S BOOKS						
Transaction		Perpetual Inventory System		Periodic Inventory System		
May 4	Purchase of merchandise on credit.	<b>Merchandise Inventory</b>	<b>3,800</b>		<b>Purchases</b>	<b>3,800</b>
		Accounts Payable	3,800		Accounts Payable	3,800
May 6	Freight costs on purchases.	<b>Merchandise Inventory</b>	<b>150</b>		<b>Freight-in</b>	<b>150</b>
		Cash	150		Cash	150
May 8	Purchase returns and allowances.	Accounts Payable	300		Accounts Payable	300
		<b>Merchandise Inventory</b>	<b>300</b>		<b>Purchase Returns and Allowances</b>	<b>300</b>
May 14	Payment on account with a discount.	Accounts Payable	3,500		Accounts Payable	3,500
		Cash	3,430		Cash	3,430
		<b>Merchandise Inventory</b>	<b>70</b>		<b>Purchase Discounts</b>	<b>70</b>
ENTRIES ON PW AUDIO SUPPLY'S BOOKS						
Transaction		Perpetual Inventory System		Periodic Inventory System		
May 4	Sale of merchandise on credit.	Accounts Receivable	3,800		Accounts Receivable	3,800
		Sales Revenue	3,800		Sales Revenue	3,800
		<b>Cost of Goods Sold</b>	<b>2,400</b>		<b>No entry for cost of goods sold</b>	
		<b>Merchandise Inventory</b>	<b>2,400</b>			
May 8	Return of merchandise sold.	Sales Returns and Allowances	300		Sales Returns and Allowances	300
		Accounts Receivable	300		Accounts Receivable	300
		<b>Merchandise Inventory</b>	<b>140</b>		<b>No entry</b>	
		<b>Cost of Goods Sold</b>	<b>140</b>			
May 14	Cash received on account with a discount.	Cash	3,430		Cash	3,430
		Sales Discounts	70		Sales Discounts	70
		Accounts Receivable	3,500		Accounts Receivable	3,500



**SUMMARY OF STUDY OBJECTIVE FOR APPENDIX 5A**

**7 Explain the recording of purchases and sales of inventory under a periodic inventory system.** In recording purchases under a periodic system, companies must make entries for (a) cash and credit purchases, (b) purchase returns

and allowances, (c) purchase discounts, and (d) freight costs. In recording sales, companies must make entries for (a) cash and credit sales, (b) sales returns and allowances, and (c) sales discounts.



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insurance, depreciation, and salaries. Pioneer Advertising Agency, as illustrated in Chapters 3 and 4, also had these adjustments. Adjustment (a) was required to adjust the perpetual inventory carrying amount to the actual count.

After PW Audio enters all adjustments data on the worksheet, it establishes the equality of the adjustments column totals. It then extends the balances in all accounts to the adjusted trial balance columns.

### ADJUSTED TRIAL BALANCE

The adjusted trial balance shows the balance of all accounts after adjustment at the end of the accounting period.

### INCOME STATEMENT COLUMNS

Next, the merchandising company transfers the accounts and balances that affect the income statement from the adjusted trial balance columns to the income statement columns. PW Audio Supply shows sales of \$480,000 in the credit column. It shows the contra-revenue accounts Sales Returns and Allowances \$12,000 and Sales Discounts \$8,000 in the debit column. The difference of \$460,000 is the net sales shown on the income statement (Illustration 5-13, page 216).

Finally, the company totals all the credits in the income statement column and compares those totals to the total of the debits in the income statement column. If the credits exceed the debits, the company has net income. PW Audio Supply has net income of \$30,000. If the debits exceed the credits, the company would report a net loss.

### BALANCE SHEET COLUMNS

The major difference between the balance sheets of a service company and a merchandiser is inventory. PW Audio Supply shows the ending inventory amount of \$40,000 in the balance sheet debit column. The information to prepare the owner's equity statement is also found in these columns. That is, the capital account of R. A. Lamb is \$83,000. The drawings for R. A. Lamb are \$15,000. Net income results when the total of the debit column exceeds the total of the credit column in the balance sheet columns. A net loss results when the total of the credits exceeds the total of the debit balances.

## SUMMARY OF STUDY OBJECTIVE

### 8 Prepare a worksheet for a merchandising company.

The steps in preparing a worksheet for a merchandising company are the same as for a service company. The unique

accounts for a merchandiser are Merchandise Inventory, Sales, Sales Returns and Allowances, Sales Discounts, and Cost of Goods Sold.

**\*Note:** All **asterisked** Questions, Exercises, and Problems relate to material in the appendices to the chapter.

## SELF-STUDY QUESTIONS



Answers are at the end of the chapter.

- (SO 1)
1. Gross profit will result if:
    - a. operating expenses are less than net income.
    - b. sales revenues are greater than operating expenses.
    - c. sales revenues are greater than cost of goods sold.
    - d. operating expenses are greater than cost of goods sold.
  2. Under a perpetual inventory system, when goods are purchased for resale by a company: (SO 2)
    - a. purchases on account are debited to Merchandise Inventory.
    - b. purchases on account are debited to Purchases.
    - c. purchase returns are debited to Purchase Returns and Allowances.
    - d. freight costs are debited to Freight-out.

- (SO 3) 3. The sales accounts that normally have a debit balance are:  
 a. Sales Discounts.  
 b. Sales Returns and Allowances.  
 c. both (a) and (b).  
 d. neither (a) nor (b).
- (SO 3) 4. A credit sale of \$750 is made on June 13, terms 2/10, net/30. A return of \$50 is granted on June 16. The amount received as payment in full on June 23 is:  
 a. \$700.  
 b. \$686.  
 c. \$685.  
 d. \$650.
- (SO 2) 5. Which of the following accounts will normally appear in the ledger of a merchandising company that uses a perpetual inventory system?  
 a. Purchases.  
 b. Freight-in.  
 c. Cost of Goods Sold.  
 d. Purchase Discounts.
- (SO 3) 6. To record the sale of goods for cash in a perpetual inventory system:  
 a. only one journal entry is necessary to record cost of goods sold and reduction of inventory.  
 b. only one journal entry is necessary to record the receipt of cash and the sales revenue.  
 c. two journal entries are necessary: one to record the receipt of cash and sales revenue, and one to record the cost of goods sold and reduction of inventory.  
 d. two journal entries are necessary: one to record the receipt of cash and reduction of inventory, and one to record the cost of goods sold and sales revenue.
- (SO 4) 7. The steps in the accounting cycle for a merchandising company are the same as those in a service company *except*:  
 a. an additional adjusting journal entry for inventory may be needed in a merchandising company.  
 b. closing journal entries are not required for a merchandising company.  
 c. a post-closing trial balance is not required for a merchandising company.  
 d. a multiple-step income statement is required for a merchandising company.
- (SO 5) 8. The multiple-step income statement for a merchandising company shows each of the following features *except*:  
 a. gross profit.  
 b. cost of goods sold.  
 c. a sales revenue section.  
 d. investing activities section.
- (SO 6) 9. If sales revenues are \$400,000, cost of goods sold is \$310,000, and operating expenses are \$60,000, the gross profit is:  
 a. \$30,000.  
 b. \$90,000.  
 c. \$340,000.  
 d. \$400,000.
10. A single-step income statement: (SO 5)  
 a. reports gross profit.  
 b. does not report cost of goods sold.  
 c. reports sales revenues and “Other revenues and gains” in the revenues section of the income statement.  
 d. reports operating income separately.
11. Which of the following appears on both a single-step and a multiple-step income statement? (SO 5)  
 a. merchandise inventory.  
 b. gross profit.  
 c. income from operations.  
 d. cost of goods sold.
- \*12. In determining cost of goods sold: (SO 7)  
 a. purchase discounts are deducted from net purchases.  
 b. freight-out is added to net purchases.  
 c. purchase returns and allowances are deducted from net purchases.  
 d. freight-in is added to net purchases.
- \*13. If beginning inventory is \$60,000, cost of goods purchased is \$380,000, and ending inventory is \$50,000, cost of goods sold is: (SO 7)  
 a. \$390,000.  
 b. \$370,000.  
 c. \$330,000.  
 d. \$420,000.
- \*14. When goods are purchased for resale by a company using a periodic inventory system: (SO 7)  
 a. purchases on account are debited to Merchandise Inventory.  
 b. purchases on account are debited to Purchases.  
 c. purchase returns are debited to Purchase Returns and Allowances.  
 d. freight costs are debited to Purchases.
- \*15. In a worksheet, Merchandise Inventory is shown in the following columns: (SO 8)  
 a. Adjusted trial balance debit and balance sheet debit.  
 b. Income statement debit and balance sheet debit.  
 c. Income statement credit and balance sheet debit.  
 d. Income statement credit and adjusted trial balance debit.


Go to the book's companion website,  
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 for Additional Self-Study questions.



## QUESTIONS

1. (a) “The steps in the accounting cycle for a merchandising company are different from the accounting cycle for a service company.” Do you agree or disagree? (b) Is the measurement of net income for a merchandising company conceptually the same as for a service company? Explain.
2. Why is the normal operating cycle for a merchandising company likely to be longer than for a service company?

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3. (a) How do the components of revenues and expenses differ between merchandising and service companies? (b) Explain the income measurement process in a merchandising company.
4. How does income measurement differ between a merchandising and a service company?
5. When is cost of goods sold determined in a perpetual inventory system?
6. Distinguish between FOB shipping point and FOB destination. Identify the freight terms that will result in a debit to Merchandise Inventory by the purchaser and a debit to Freight-out by the seller.
7. Explain the meaning of the credit terms 2/10, n/30.
8. Goods costing \$2,000 are purchased on account on July 15 with credit terms of 2/10, n/30. On July 18 a \$200 credit memo is received from the supplier for damaged goods. Give the journal entry on July 24 to record payment of the balance due within the discount period using a perpetual inventory system.
9. Joan Roland believes revenues from credit sales may be earned before they are collected in cash. Do you agree? Explain.
10. (a) What is the primary source document for recording (1) cash sales, (2) credit sales. (b) Using XXs for amounts, give the journal entry for each of the transactions in part (a).
11. A credit sale is made on July 10 for \$900, terms 2/10, n/30. On July 12, \$100 of goods are returned for credit. Give the journal entry on July 19 to record the receipt of the balance due within the discount period.
12. Explain why the Merchandise Inventory account will usually require adjustment at year-end.
13. Prepare the closing entries for the Sales account, assuming a balance of \$200,000 and the Cost of Goods Sold account with a \$145,000 balance.
14. What merchandising account(s) will appear in the post-closing trial balance?
15. Reese Co. has sales revenue of \$105,000, cost of goods sold of \$70,000, and operating expenses of \$20,000. What is its gross profit and its gross profit rate?
16. Ann Fort Company reports net sales of \$800,000, gross profit of \$370,000, and net income of \$240,000. What are its operating expenses?
17. Identify the distinguishing features of an income statement for a merchandising company.
18. Identify the sections of a multiple-step income statement that relate to (a) operating activities, and (b) nonoperating activities.
19. How does the single-step form of income statement differ from the multiple-step form?
20.  **PEPSICO** Determine **PepsiCo's** gross profit rate for 2007 and 2006. Indicate whether it increased or decreased from 2006 to 2007.
- \*21. Identify the accounts that are added to or deducted from Purchases to determine the cost of goods purchased. For each account, indicate whether it is added or deducted.
- \*22. Goods costing \$3,000 are purchased on account on July 15 with credit terms of 2/10, n/30. On July 18 a \$200 credit was received from the supplier for damaged goods. Give the journal entry on July 24 to record payment of the balance due within the discount period, assuming a periodic inventory system.
- \*23. Indicate the columns of the work sheet in which (a) merchandise inventory and (b) cost of goods sold will be shown.

### BRIEF EXERCISES



Compute missing amounts in determining net income.

(SO 1)

**BE5-1** Presented below are the components in Waegelain Company's income statement. Determine the missing amounts.

	<u>Sales</u>	<u>Cost of Goods Sold</u>	<u>Gross Profit</u>	<u>Operating Expenses</u>	<u>Net Income</u>
(a)	\$75,000	?	\$30,000	?	\$10,800
(b)	\$108,000	\$70,000	?	?	\$29,500
(c)	?	\$71,900	\$79,600	\$39,500	?

Journalize perpetual inventory entries.

(SO 2, 3)

**BE5-2** Hollins Company buys merchandise on account from Gordon Company. The selling price of the goods is \$780, and the cost of the goods is \$520. Both companies use perpetual inventory systems. Journalize the transaction on the books of both companies.

Journalize sales transactions.

(SO 3)

**BE5-3** Prepare the journal entries to record the following transactions on Monroe Company's books using a perpetual inventory system.

- (a) On March 2, Monroe Company sold \$900,000 of merchandise to Churchill Company, terms 2/10, n/30. The cost of the merchandise sold was \$620,000.

- (b) On March 6, Churchill Company returned \$120,000 of the merchandise purchased on March 2. The cost of the returned merchandise was \$90,000.
- (c) On March 12, Monroe Company received the balance due from Churchill Company.

**BE5-4** From the information in BE5-3, prepare the journal entries to record these transactions on Churchill Company's books under a perpetual inventory system.

*Journalize purchase transactions.*

(SO 2)

**BE5-5** At year-end the perpetual inventory records of Garbo Company showed merchandise inventory of \$98,000. The company determined, however, that its actual inventory on hand was \$96,500. Record the necessary adjusting entry.

*Prepare adjusting entry for merchandise inventory.*

(SO 4)

**BE5-6** Bleeker Company has the following merchandise account balances: Sales \$195,000, Sales Discounts \$2,000, Cost of Goods Sold \$105,000, and Merchandise Inventory \$40,000. Prepare the entries to record the closing of these items to Income Summary.


*Prepare closing entries for merchandise accounts.*

(SO 4)

**BE5-7** Maulder Company provides the following information for the month ended October 31, 2010: Sales on credit \$280,000, cash sales \$100,000, sales discounts \$13,000, sales returns and allowances \$11,000. Prepare the sales revenues section of the income statement based on this information.

*Prepare sales revenues section of income statement.*

(SO 5)

**BE5-8**  Explain where each of the following items would appear on (1) a multiple-step income statement, and on (2) a single-step income statement: (a) gain on sale of equipment, (b) interest expense, (c) casualty loss from vandalism, and (d) cost of goods sold.

*Contrast presentation in multiple-step and single-step income statements.*

(SO 5)

**BE5-9** Assume Baja Company has the following reported amounts: Sales \$510,000, Sales returns and allowances \$15,000, Cost of goods sold \$350,000, Operating expenses \$110,000. Compute the following: (a) net sales, (b) gross profit, (c) income from operations, and (d) gross profit rate. (Round to one decimal place.)

*Compute net sales, gross profit, income from operations, and gross profit rate.*

(SO 5, 6)

**\*BE5-10** Assume that Alshare Company uses a periodic inventory system and has these account balances: Purchases \$450,000; Purchase Returns and Allowances \$11,000; Purchase Discounts \$8,000; and Freight-in \$16,000. Determine net purchases and cost of goods purchased.

*Compute net purchases and cost of goods purchased.*

(SO 7)

**\*BE5-11** Assume the same information as in BE5-10 and also that Alshare Company has beginning inventory of \$60,000, ending inventory of \$90,000, and net sales of \$630,000. Determine the amounts to be reported for cost of goods sold and gross profit.

*Compute cost of goods sold and gross profit.*

(SO 6, 7)

**\*BE5-12** Prepare the journal entries to record these transactions on Allied Company's books using a periodic inventory system.

*Journalize purchase transactions.*

- (a) On March 2, Allied Company purchased \$1,000,000 of merchandise from B. Streisand Company, terms 2/10, n/30.
- (b) On March 6 Allied Company returned \$130,000 of the merchandise purchased on March 2.
- (c) On March 12 Allied Company paid the balance due to B. Streisand Company.

(SO 7)

**\*BE5-13** Presented below is the format of the worksheet presented in the chapter.

*Identify worksheet columns for selected accounts.*

(SO 8)

Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.

Indicate where the following items will appear on the worksheet: (a) Cash, (b) Merchandise Inventory, (c) Sales, (d) Cost of goods sold.

*Example:*

Cash: Trial balance debit column; Adjusted trial balance debit column; and Balance sheet debit column.



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**DO IT! REVIEW**



Record transactions of purchasing company.

(SO 2)

**DO IT! 5-1** On October 5, Lane Company buys merchandise on account from O'Brien Company. The selling price of the goods is \$5,000, and the cost to O'Brien Company is \$3,000. On October 8, Lane returns defective goods with a selling price of \$700 and a scrap value of \$250. Record the transactions on the books of Lane Company.

Record transactions of selling company.

(SO 3)

**DO IT! 5-2** Assume information similar to that in Do It! 5-1. That is: On October 5, Lane Company buys merchandise on account from O'Brien Company. The selling price of the goods is \$5,000, and the cost to O'Brien Company is \$3,000. On October 8, Lane returns defective goods with a selling price of \$700 and a scrap value of \$250. Record the transactions on the books of O'Brien Company.

Prepare closing entries for a merchandising company.

(SO 4)

**DO IT! 5-3** The trial balance of Dionne's Boutique at December 31 shows Merchandise Inventory \$21,000, Sales \$136,000, Sales Returns and Allowances \$4,000, Sales Discounts \$3,000, Cost of Goods Sold \$92,400, Interest Revenue \$5,000, Freight-out \$1,500, Utilities Expense \$7,400, Salaries Expense \$18,500. Prepare the closing entries for the Dionne's accounts.

Classify financial statement accounts.

(SO 5)

**DO IT! 5-4** Smith Company is preparing its multiple-step income statement, statement of owner's equity, and classified balance sheet. Using the column heads *Account*, *Financial Statement*, and *Classification*, indicate in which financial statement and under what classification each of the following would be reported.

<u>Account</u>	<u>Financial Statement</u>	<u>Classification</u>
Accounts Payable		
Accounts Receivable		
Accumulated Depreciation— Office Building		
Cash		
Casualty Loss from Vandalism		
Cost of Goods Sold		
Delivery Equipment		
Depreciation Expense		
E. Smith, Capital		
E. Smith, Drawing		
Freight-out		
Insurance Expense		
Interest Payable		
Land		
Merchandise Inventory		
Notes Payable (due in 5 years)		
Property Tax Payable		
Salaries Expense		
Salaries Payable		
Sales Returns and Allowances		
Sales Revenues		
Unearned Rent		
Utilities Expense		
Warehouse		

**EXERCISES**



Answer general questions about merchandisers.

(SO 1)

**E5-1** Mr. Wellington has prepared the following list of statements about service companies and merchandisers.

1. Measuring net income for a merchandiser is conceptually the same as for a service company.
2. For a merchandiser, sales less operating expenses is called gross profit.
3. For a merchandiser, the primary source of revenues is the sale of inventory.
4. Sales salaries is an example of an operating expense.
5. The operating cycle of a merchandiser is the same as that of a service company.
6. In a perpetual inventory system, no detailed inventory records of goods on hand are maintained.

7. In a periodic inventory system, the cost of goods sold is determined only at the end of the accounting period.
8. A periodic inventory system provides better control over inventories than a perpetual system.

**Instructions**

Identify each statement as true or false. If false, indicate how to correct the statement.

**E5-2** Information related to Steffens Co. is presented below.

1. On April 5, purchased merchandise from Bryant Company for \$25,000 terms 2/10, net/30, FOB shipping point.
2. On April 6 paid freight costs of \$900 on merchandise purchased from Bryant.
3. On April 7, purchased equipment on account for \$26,000.
4. On April 8, returned damaged merchandise to Bryant Company and was granted a \$4,000 credit for returned merchandise.
5. On April 15 paid the amount due to Bryant Company in full.

*Journalize purchases transactions.*

(SO 2)

**Instructions**

- (a) Prepare the journal entries to record these transactions on the books of Steffens Co. under a perpetual inventory system.
- (b) Assume that Steffens Co. paid the balance due to Bryant Company on May 4 instead of April 15. Prepare the journal entry to record this payment.

**E5-3** On September 1, Howe Office Supply had an inventory of 30 calculators at a cost of \$18 each. The company uses a perpetual inventory system. During September, the following transactions occurred.

*Journalize perpetual inventory entries.*

(SO 2, 3)

- Sept. 6 Purchased 80 calculators at \$20 each from DeVito Co. for cash.  
 9 Paid freight of \$80 on calculators purchased from DeVito Co.  
 10 Returned 2 calculators to DeVito Co. for \$42 credit (including freight) because they did not meet specifications.  
 12 Sold 26 calculators costing \$21 (including freight) for \$31 each to Mega Book Store, terms n/30.  
 14 Granted credit of \$31 to Mega Book Store for the return of one calculator that was not ordered.  
 20 Sold 30 calculators costing \$21 for \$31 each to Barbara's Card Shop, terms n/30.

**Instructions**

Journalize the September transactions.

**E5-4** On June 10, Meredith Company purchased \$8,000 of merchandise from Leinert Company, FOB shipping point, terms 2/10, n/30. Meredith pays the freight costs of \$400 on June 11. Damaged goods totaling \$300 are returned to Leinert for credit on June 12. The scrap value of these goods is \$150. On June 19, Meredith pays Leinert Company in full, less the purchase discount. Both companies use a perpetual inventory system.

*Prepare purchase and sale entries.*

(SO 2, 3)

**Instructions**

- (a) Prepare separate entries for each transaction on the books of Meredith Company.
- (b) Prepare separate entries for each transaction for Leinert Company. The merchandise purchased by Meredith on June 10 had cost Leinert \$5,000.

**E5-5** Presented below are transactions related to Wheeler Company.

*Journalize sales transactions.*

1. On December 3, Wheeler Company sold \$500,000 of merchandise to Hashmi Co., terms 2/10, n/30, FOB shipping point. The cost of the merchandise sold was \$350,000.
2. On December 8, Hashmi Co. was granted an allowance of \$27,000 for merchandise purchased on December 3.
3. On December 13, Wheeler Company received the balance due from Hashmi Co.

(SO 3)

**Instructions**

- (a) Prepare the journal entries to record these transactions on the books of Wheeler Company using a perpetual inventory system.
- (b) Assume that Wheeler Company received the balance due from Hashmi Co. on January 2 of the following year instead of December 13. Prepare the journal entry to record the receipt of payment on January 2.

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Prepare sales revenues section and closing entries.

(SO 4, 5)

**E5-6** The adjusted trial balance of Zambrana Company shows the following data pertaining to sales at the end of its fiscal year October 31, 2010: Sales \$800,000, Freight-out \$16,000, Sales Returns and Allowances \$25,000, and Sales Discounts \$15,000.

### Instructions

- Prepare the sales revenues section of the income statement.
- Prepare separate closing entries for (1) sales, and (2) the contra accounts to sales.

Prepare adjusting and closing entries.

(SO 4)

**E5-7** Peter Kalle Company had the following account balances at year-end: cost of goods sold \$60,000; merchandise inventory \$15,000; operating expenses \$29,000; sales \$108,000; sales discounts \$1,200; and sales returns and allowances \$1,700. A physical count of inventory determines that merchandise inventory on hand is \$14,100.

### Instructions

- Prepare the adjusting entry necessary as a result of the physical count.
- Prepare closing entries.

Prepare adjusting and closing entries.

(SO 4)

**E5-8** Presented is information related to Rogers Co. for the month of January 2010.

Ending inventory per perpetual records	\$ 21,600	Insurance expense	\$ 12,000
Ending inventory actually on hand	21,000	Rent expense	20,000
Cost of goods sold	218,000	Salary expense	61,000
Freight-out	7,000	Sales discounts	10,000
		Sales returns and allowances	13,000
		Sales	350,000

### Instructions

- Prepare the necessary adjusting entry for inventory.
- Prepare the necessary closing entries.

Prepare multiple-step income statement.

(SO 5, 6)

**E5-9** Presented below is information for Obley Company for the month of March 2010.

Cost of goods sold	\$212,000	Rent expense	\$ 32,000
Freight-out	7,000	Sales discounts	8,000
Insurance expense	12,000	Sales returns and allowances	13,000
Salary expense	58,000	Sales	370,000

### Instructions

- Prepare a multiple-step income statement.
- Compute the gross profit rate.

Prepare multiple-step and single-step income statements.

(SO 5)



**E5-10** In its income statement for the year ended December 31, 2010, Pele Company reported the following condensed data.

Operating expenses	\$ 925,000	Interest revenue	\$ 28,000
Cost of goods sold	1,289,000	Loss on sale of equipment	10,000
Interest expense	\$ 70,000	Net sales	2,312,000

### Instructions

- Prepare a multiple-step income statement.
- Prepare a single-step income statement.

Prepare correcting entries for sales and purchases.

(SO 2, 3)

**E5-11** An inexperienced accountant for Blaufuss Company made the following errors in recording merchandising transactions.

- A \$175 refund to a customer for faulty merchandise was debited to Sales \$175 and credited to Cash \$175.
- A \$180 credit purchase of supplies was debited to Merchandise Inventory \$180 and credited to Cash \$180.

3. A \$110 sales discount was debited to Sales.
4. A cash payment of \$20 for freight on merchandise purchases was debited to Freight-out \$200 and credited to Cash \$200.

**Instructions**

Prepare separate correcting entries for each error, assuming that the incorrect entry is not reversed. (Omit explanations.)

**E5-12** In 2010, Walter Payton Company had net sales of \$900,000 and cost of goods sold of \$540,000. Operating expenses were \$230,000, and interest expense was \$11,000. Payton prepares a multiple-step income statement.

*Compute various income measures.*

(SO 5, 6)

**Instructions**

- (a) Compute Payton's gross profit.
- (b) Compute the gross profit rate. Why is this rate computed by financial statement users?
- (c) What is Payton's income from operations and net income?
- (d) If Payton prepared a single-step income statement, what amount would it report for net income?
- (e) In what section of its classified balance sheet should Payton report merchandise inventory?

**E5-13** Presented below is financial information for two different companies.

*Compute missing amounts and compute gross profit rate.*

(SO 5, 6)

	<u>Nam Company</u>	<u>Mayo Company</u>
Sales	\$90,000	(d)
Sales returns	(a)	\$ 5,000
Net sales	84,000	100,000
Cost of goods sold	56,000	(e)
Gross profit	(b)	41,500
Operating expenses	15,000	(f)
Net income	(c)	15,000

**Instructions**

- (a) Determine the missing amounts.
- (b) Determine the gross profit rates. (Round to one decimal place.)

**E5-14** Financial information is presented below for three different companies.

*Compute missing amounts.*

(SO 5)

	<u>Natural Cosmetics</u>	<u>Mattar Grocery</u>	<u>Allied Wholesalers</u>
Sales	\$90,000	\$ (e)	\$144,000
Sales returns and allowances	(a)	5,000	12,000
Net sales	81,000	95,000	(i)
Cost of goods sold	56,000	(f)	(j)
Gross profit	(b)	38,000	24,000
Operating expenses	15,000	(g)	18,000
Income from operations	(c)	(h)	(k)
Other expenses and losses	4,000	7,000	(l)
Net income	(d)	11,000	5,000

**Instructions**

Determine the missing amounts.

**\*E5-15** The trial balance of G. Durler Company at the end of its fiscal year, August 31, 2010, includes these accounts: Merchandise Inventory \$17,200; Purchases \$149,000; Sales \$190,000; Freight-in \$4,000; Sales Returns and Allowances \$3,000; Freight-out \$1,000; and Purchase Returns and Allowances \$2,000. The ending merchandise inventory is \$25,000.

*Prepare cost of goods sold section.*

(SO 7)

**Instructions**

Prepare a cost of goods sold section for the year ending August 31 (periodic inventory).

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Compute various income statement items.

(SO 7)

**\*E5-16** On January 1, 2010, Rachael Ray Corporation had merchandise inventory of \$50,000. At December 31, 2010, Rachael Ray had the following account balances.

Freight-in	\$ 4,000
Purchases	500,000
Purchase discounts	6,000
Purchase returns and allowances	2,000
Sales	800,000
Sales discounts	5,000
Sales returns and allowances	10,000

At December 31, 2010, Rachael Ray determines that its ending inventory is \$60,000.

### Instructions

- Compute Rachael Ray's 2010 gross profit.
- Compute Rachael Ray's 2010 operating expenses if net income is \$130,000 and there are no nonoperating activities.

Prepare cost of goods sold section.

(SO 7)

**\*E5-17** Below is a series of cost of goods sold sections for companies B, F, L, and R.

	<u>B</u>	<u>F</u>	<u>L</u>	<u>R</u>
Beginning inventory	\$ 150	\$ 70	\$1,000	\$ (j)
Purchases	1,600	1,080	(g)	43,590
Purchase returns and allowances	40	(d)	290	(k)
Net purchases	(a)	1,030	6,210	41,090
Freight-in	110	(e)	(h)	2,240
Cost of goods purchased	(b)	1,280	7,940	(l)
Cost of goods available for sale	1,820	1,350	(i)	49,530
Ending inventory	310	(f)	1,450	6,230
Cost of goods sold	(c)	1,230	7,490	43,300

### Instructions

Fill in the lettered blanks to complete the cost of goods sold sections.

Journalize purchase transactions.

(SO 7)

**\*E5-18** This information relates to Martinez Co.

- On April 5 purchased merchandise from D. Norlan Company for \$20,000, terms 2/10, net/30, FOB shipping point.
- On April 6 paid freight costs of \$900 on merchandise purchased from D. Norlan Company.
- On April 7 purchased equipment on account for \$26,000.
- On April 8 returned some of April 5 merchandise, which cost \$2,800, to D. Norlan Company.
- On April 15 paid the amount due to D. Norlan Company in full.

### Instructions

- Prepare the journal entries to record these transactions on the books of Martinez Co. using a periodic inventory system.
- Assume that Martinez Co. paid the balance due to D. Norlan Company on May 4 instead of April 15. Prepare the journal entry to record this payment.

Journalize purchase transactions.

(SO 7)

**\*E5-19** Presented below is information related to Chevalier Co.

- On April 5, purchased merchandise from Paris Company for \$22,000, terms 2/10, net/30, FOB shipping point.
- On April 6, paid freight costs of \$800 on merchandise purchased from Paris.
- On April 7, purchased equipment on account from Wayne Higley Mfg. Co. for \$26,000.
- On April 8, returned merchandise, which cost \$4,000, to Paris Company.
- On April 15, paid the amount due to Paris Company in full.

### Instructions

- Prepare the journal entries to record these transactions on the books of Chevalier Co. using a periodic inventory system.
- Assume that Chevalier Co. paid the balance due to Paris Company on May 4 instead of April 15. Prepare the journal entry to record this payment.

**\*E5-20** Presented below are selected accounts for Carpenter Company as reported in the worksheet at the end of May 2010.

Complete worksheet.  
(SO 8)

Accounts	Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	9,000					
Merchandise Inventory	76,000					
Sales		450,000				
Sales Returns and Allowances	10,000					
Sales Discounts	9,000					
Cost of Goods Sold	300,000					

**Instructions**

Complete the worksheet by extending amounts reported in the adjusted trial balance to the appropriate columns in the work sheet. Do not total individual columns.

**\*E5-21** The trial balance columns of the worksheet for Green Company at June 30, 2010, are as follows.

Prepare a worksheet.  
(SO 8)

**GREEN COMPANY**

Worksheet  
For the Month Ended June 30, 2010

Account Titles	Trial Balance	
	Debit	Credit
Cash	\$ 2,320	
Accounts Receivable	2,440	
Merchandise Inventory	11,640	
Accounts Payable		\$ 1,120
Ed Green, Capital		3,600
Sales		42,400
Cost of Goods Sold	20,560	
Operating Expenses	10,160	
	<u>\$47,120</u>	<u>\$47,120</u>

Other data:

Operating expenses incurred on account, but not yet recorded, total \$1,500.

**Instructions**

Enter the trial balance on a worksheet and complete the worksheet.

**EXERCISES: SET B**

Visit the book's companion website at [www.wiley.com/college/veygandt](http://www.wiley.com/college/veygandt), and choose the Student Companion site, to access Exercise Set B.



**PROBLEMS: SET A**

**P5-1A** Sansomite Co. distributes suitcases to retail stores and extends credit terms of 1/10, n/30 to all of its customers. At the end of June, Sansomite's inventory consisted of suitcases costing \$1,200. During the month of July the following merchandising transactions occurred.

Journalize purchase and sales transactions under a perpetual inventory system.

July 1 Purchased suitcases on account for \$1,800 from Trunk Manufacturers, FOB destination, terms 2/10, n/30. The appropriate party also made a cash payment of \$100 for freight on this date.

(SO 2, 3)





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- 3 Sold suitcases on account to Satchel World for \$2,000. The cost of suitcases sold is \$1,200.
- 9 Paid Trunk Manufacturers in full.
- 12 Received payment in full from Satchel World.
- 17 Sold suitcases on account to The Going Concern for \$1,500. The cost of the suitcases sold was \$900.
- 18 Purchased suitcases on account for \$1,700 from Kingman Manufacturers, FOB shipping point, terms 1/10, n/30. The appropriate party also made a cash payment of \$100 for freight on this date.
- 20 Received \$300 credit (including freight) for suitcases returned to Kingman Manufacturers.
- 21 Received payment in full from The Going Concern.
- 22 Sold suitcases on account to Fly-By-Night for \$2,250. The cost of suitcases sold was \$1,350.
- 30 Paid Kingman Manufacturers in full.
- 31 Granted Fly-By-Night \$200 credit for suitcases returned costing \$120.

Sansomite's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 201 Accounts Payable, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 505 Cost of Goods Sold.

### Instructions

Journalize the transactions for the month of July for Sansomite using a perpetual inventory system.

Journalize, post, and prepare a partial income statement.

(SO 2, 3, 5, 6)



**P5-2A** Olaf Distributing Company completed the following merchandising transactions in the month of April. At the beginning of April, the ledger of Olaf showed Cash of \$9,000 and M. Olaf, Capital of \$9,000.

- Apr. 2 Purchased merchandise on account from Dakota Supply Co. \$6,900, terms 1/10, n/30.
- 4 Sold merchandise on account \$5,500, FOB destination, terms 1/10, n/30. The cost of the merchandise sold was \$4,100.
  - 5 Paid \$240 freight on April 4 sale.
  - 6 Received credit from Dakota Supply Co. for merchandise returned \$500.
  - 11 Paid Dakota Supply Co. in full, less discount.
  - 13 Received collections in full, less discounts, from customers billed on April 4.
  - 14 Purchased merchandise for cash \$3,800.
  - 16 Received refund from supplier for returned goods on cash purchase of April 14, \$500.
  - 18 Purchased merchandise from Skywalker Distributors \$4,500, FOB shipping point, terms 2/10, n/30.
  - 20 Paid freight on April 18 purchase \$100.
  - 23 Sold merchandise for cash \$6,400. The merchandise sold had a cost of \$5,120.
  - 26 Purchased merchandise for cash \$2,300.
  - 27 Paid Skywalker Distributors in full, less discount.
  - 29 Made refunds to cash customers for defective merchandise \$90. The returned merchandise had a scrap value of \$30.
  - 30 Sold merchandise on account \$3,700, terms n/30. The cost of the merchandise sold was \$2,800.

Olaf Company's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 201 Accounts Payable, No. 301 M. Olaf, Capital, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 505 Cost of Goods Sold, and No. 644 Freight-out.

### Instructions

- (a) Journalize the transactions using a perpetual inventory system.
- (b) Enter the beginning cash and capital balances, and post the transactions. (Use J1 for the journal reference.)
- (c) Prepare the income statement through gross profit for the month of April 2010.

(c) Gross profit \$3,465

Prepare financial statements and adjusting and closing entries.

(SO 4, 5)

**P5-3A** Maine Department Store is located near the Village Shopping Mall. At the end of the company's calendar year on December 31, 2010, the following accounts appeared in two of its trial balances.

	<u>Unadjusted</u>	<u>Adjusted</u>		<u>Unadjusted</u>	<u>Adjusted</u>
Accounts Payable	\$ 79,300	\$ 79,300	Interest Payable		\$ 8,000
Accounts Receivable	50,300	50,300	Interest Revenue	\$ 4,000	4,000
Accumulated Depr.—Building	42,100	52,500	Merchandise Inventory	75,000	75,000
Accumulated Depr.—Equipment	29,600	42,900	Mortgage Payable	80,000	80,000
Building	190,000	190,000	Office Salaries Expense	32,000	32,000
Cash	23,800	23,800	Prepaid Insurance	9,600	2,400
B. Maine, Capital	176,600	176,600	Property Tax Expense		4,800
Cost of Goods Sold	412,700	412,700	Property Taxes Payable		4,800
Depr. Expense—Building		10,400	Sales Salaries Expense	76,000	76,000
Depr. Expense—Equipment		13,300	Sales	628,000	628,000
B. Maine, Drawing	28,000	28,000	Sales Commissions Expense	10,200	14,500
Equipment	110,000	110,000	Sales Commissions Payable		4,300
Insurance Expense		7,200	Sales Returns and Allowances	8,000	8,000
Interest Expense	3,000	11,000	Utilities Expense	11,000	12,000
			Utilities Expense Payable		1,000

### Instructions

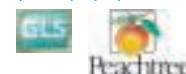
- Prepare a multiple-step income statement, an owner's equity statement, and a classified balance sheet. \$20,000 of the mortgage payable is due for payment next year.
- Journalize the adjusting entries that were made.
- Journalize the closing entries that are necessary.

(a) Net income \$30,100  
Capital \$178,700  
Total assets \$356,100

**P5-4A** J. Hafner, a former professional tennis star, operates Hafner's Tennis Shop at the Miller Lake Resort. At the beginning of the current season, the ledger of Hafner's Tennis Shop showed Cash \$2,500, Merchandise Inventory \$1,700, and J. Hafner, Capital \$4,200. The following transactions were completed during April.

Journalize, post, and prepare a trial balance.

(SO 2, 3, 4)



- Apr. 4 Purchased racquets and balls from Wellman Co. \$840, FOB shipping point, terms 2/10, n/30.
- 6 Paid freight on purchase from Wellman Co. \$40.
- 8 Sold merchandise to members \$1,150, terms n/30. The merchandise sold had a cost of \$790.
- 10 Received credit of \$40 from Wellman Co. for a racquet that was returned.
- 11 Purchased tennis shoes from Venus Sports for cash, \$420.
- 13 Paid Wellman Co. in full.
- 14 Purchased tennis shirts and shorts from Serena's Sportswear \$900, FOB shipping point, terms 3/10, n/60.
- 15 Received cash refund of \$50 from Venus Sports for damaged merchandise that was returned.
- 17 Paid freight on Serena's Sportswear purchase \$30.
- 18 Sold merchandise to members \$810, terms n/30. The cost of the merchandise sold was \$530.
- 20 Received \$500 in cash from members in settlement of their accounts.
- 21 Paid Serena's Sportswear in full.
- 27 Granted an allowance of \$30 to members for tennis clothing that did not fit properly.
- 30 Received cash payments on account from members, \$660.

The chart of accounts for the tennis shop includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 201 Accounts Payable, No. 301 J. Hafner, Capital, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 505 Cost of Goods Sold.

### Instructions

- Journalize the April transactions using a perpetual inventory system.
- Enter the beginning balances in the ledger accounts and post the April transactions. (Use J1 for the journal reference.)
- Prepare a trial balance on April 30, 2010.

(c) Total debits \$6,160

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Determine cost of goods sold and gross profit under periodic approach.

(SO 6, 7)

**\*P5-5A** At the end of Gordman Department Store's fiscal year on December 31, 2010, these accounts appeared in its adjusted trial balance.

Freight-in	\$ 5,600
Merchandise Inventory	40,500
Purchases	447,000
Purchase Discounts	12,000
Purchase Returns and Allowances	6,400
Sales	718,000
Sales Returns and Allowances	8,000

Additional facts:

1. Merchandise inventory on December 31, 2010, is \$75,000.
2. Note that Gordman Department Store uses a periodic system.

### Instructions

Prepare an income statement through gross profit for the year ended December 31, 2010.

Gross profit \$310,300

Calculate missing amounts and assess profitability.

(SO 6, 7)

**\*P5-6A** Kristen Montana operates a retail clothing operation. She purchases all merchandise inventory on credit and uses a periodic inventory system. The accounts payable account is used for recording inventory purchases only; all other current liabilities are accrued in separate accounts. You are provided with the following selected information for the fiscal years 2007, 2008, 2009, and 2010.

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Inventory (ending)	\$ 13,000	\$ 11,300	\$ 14,700	\$ 12,200
Accounts payable (ending)	20,000			
Sales		225,700	227,600	219,500
Purchases of merchandise inventory on account		146,000	145,000	129,000
Cash payments to suppliers		135,000	161,000	127,000

### Instructions

- (a) Calculate cost of goods sold for each of the 2008, 2009, and 2010 fiscal years.
- (b) Calculate the gross profit for each of the 2008, 2009, and 2010 fiscal years.
- (c) Calculate the ending balance of accounts payable for each of the 2008, 2009, and 2010 fiscal years.
- (d) Sales declined in fiscal 2010. Does that mean that profitability, as measured by the gross profit rate, necessarily also declined? Explain, calculating the gross profit rate for each fiscal year to help support your answer. (Round to one decimal place.)

(a) 2009 \$141,600

(c) 2009 Ending accts payable \$15,000

Journalize, post, and prepare trial balance and partial income statement using periodic approach.

(SO 7)



**\*P5-7A** At the beginning of the current season, the ledger of Village Tennis Shop showed Cash \$2,500; Merchandise Inventory \$1,700; and Angie Wilbert, Capital \$4,200. The following transactions were completed during April.

- Apr. 4 Purchased racquets and balls from Denton Co. \$740, terms 3/10, n/30.
- 6 Paid freight on Denton Co. purchase \$60.
- 8 Sold merchandise to members \$900, terms n/30.
- 10 Received credit of \$40 from Denton Co. for a racquet that was returned.
- 11 Purchased tennis shoes from Newbee Sports for cash \$300.
- 13 Paid Denton Co. in full.
- 14 Purchased tennis shirts and shorts from Venus's Sportswear \$600, terms 2/10, n/60.
- 15 Received cash refund of \$50 from Newbee Sports for damaged merchandise that was returned.
- 17 Paid freight on Venus's Sportswear purchase \$30.
- 18 Sold merchandise to members \$1,000, terms n/30.
- 20 Received \$500 in cash from members in settlement of their accounts.
- 21 Paid Venus's Sportswear in full.
- 27 Granted an allowance of \$30 to members for tennis clothing that did not fit properly.
- 30 Received cash payments on account from members \$500.

The chart of accounts for the tennis shop includes Cash; Accounts Receivable; Merchandise Inventory; Accounts Payable; Angie Wilbert, Capital; Sales; Sales Returns and Allowances; Purchases; Purchase Returns and Allowances; Purchase Discounts; and Freight-in.

**Instructions**

- (a) Journalize the April transactions using a periodic inventory system.
- (b) Using T accounts, enter the beginning balances in the ledger accounts and post the April transactions.
- (c) Prepare a trial balance on April 30, 2010.
- (d) Prepare an income statement through gross profit, assuming merchandise inventory on hand at April 30 is \$2,296.

(c) Tot. trial balance \$6,223  
(d) Gross profit \$ 859

**\*P5-8A** The trial balance of Terry Manning Fashion Center contained the following accounts at November 30, the end of the company's fiscal year.

Complete accounting cycle beginning with a worksheet.

(SO 4, 5, 6, 8)



**TERRY MANNING FASHION CENTER**

Trial Balance  
November 30, 2010

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 28,700	
Accounts Receivable	30,700	
Merchandise Inventory	44,700	
Store Supplies	6,200	
Store Equipment	85,000	
Accumulated Depreciation—Store Equipment		\$ 22,000
Delivery Equipment	48,000	
Accumulated Depreciation—Delivery Equipment		6,000
Notes Payable		51,000
Accounts Payable		48,500
Terry Manning, Capital		110,000
Terry Manning, Drawing	12,000	
Sales		755,200
Sales Returns and Allowances	8,800	
Cost of Goods Sold	497,400	
Salaries Expense	140,000	
Advertising Expense	24,400	
Utilities Expense	14,000	
Repair Expense	12,100	
Delivery Expense	16,700	
Rent Expense	24,000	
Totals	<u>\$992,700</u>	<u>\$992,700</u>

Adjustment data:

1. Store supplies on hand totaled \$2,500.
2. Depreciation is \$9,000 on the store equipment and \$5,000 on the delivery equipment.
3. Interest of \$4,080 is accrued on notes payable at November 30.
4. Merchandise inventory actually on hand is \$44,400.

**Instructions**

- (a) Enter the trial balance on a worksheet, and complete the worksheet.
- (b) Prepare a multiple-step income statement and an owner's equity statement for the year, and a classified balance sheet as of November 30, 2010. Notes payable of \$30,000 are due in January 2011.
- (c) Journalize the adjusting entries.
- (d) Journalize the closing entries.
- (e) Prepare a post-closing trial balance.

(a) Adj. trial balance  
\$1,010,780  
Net loss \$4,280  
(b) Gross profit \$248,700  
Total assets \$197,300

**PROBLEMS: SET B**

**P5-1B** Paul's Book Warehouse distributes hardcover books to retail stores and extends credit terms of 2/10, n/30 to all of its customers. At the end of May, Paul's inventory consisted of books purchased for \$1,800. During June the following merchandising transactions occurred.

Journalize purchase and sales transactions under a perpetual inventory system.

(SO 2, 3)



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- June 1 Purchased books on account for \$1,200 from Logan Publishers, FOB destination, terms 2/10, n/30. The appropriate party also made a cash payment of \$50 for the freight on this date.
- 3 Sold books on account to Reading Rainbow for \$2,400.
- 6 Received \$100 credit for books returned to Logan Publishers.
- 9 Paid Logan Publishers in full, less discount.
- 15 Received payment in full from Reading Rainbow.
- 17 Sold books on account to Cheap Books for \$1,800. The cost of the books sold was \$1,080.
- 20 Purchased books on account for \$1,500 from Phantom Publishers, FOB destination, terms 2/15, n/30. The appropriate party also made a cash payment of \$50 for the freight on this date.
- 24 Received payment in full from Cheap Books.
- 26 Paid Phantom Publishers in full, less discount.
- 28 Sold books on account to Willow Bookstore for \$1,300. The cost of the books sold was \$780.
- 30 Granted Willow Bookstore \$120 credit for books returned costing \$72.

Paul's Book Warehouse's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 201 Accounts Payable, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 505 Cost of Goods Sold.

### Instructions

Journalize the transactions for the month of June for Paul's Book Warehouse using a perpetual inventory system.

*Journalize, post, and prepare a partial income statement.*

(SO 2, 3, 5, 6)



**P5-2B** Newman Hardware Store completed the following merchandising transactions in the month of May. At the beginning of May, the ledger of Newman showed Cash of \$5,000 and Newman, Capital of \$5,000.

- May 1 Purchased merchandise on account from Jerry's Wholesale Supply \$4,200, terms 2/10, n/30.
- 2 Sold merchandise on account \$2,100, terms 1/10, n/30. The cost of the merchandise sold was \$1,300.
- 5 Received credit from Jerry's Wholesale Supply for merchandise returned \$300.
- 9 Received collections in full, less discounts, from customers billed on sales of \$2,100 on May 2.
- 10 Paid Jerry's Wholesale Supply in full, less discount.
- 11 Purchased supplies for cash \$400.
- 12 Purchased merchandise for cash \$1,400.
- 15 Received refund for poor quality merchandise from supplier on cash purchase \$150.
- 17 Purchased merchandise from Cosmo Distributors \$1,300, FOB shipping point, terms 2/10, n/30.
- 19 Paid freight on May 17 purchase \$130.
- 24 Sold merchandise for cash \$3,200. The merchandise sold had a cost of \$2,000.
- 25 Purchased merchandise from Costanza, Inc. \$550, FOB destination, terms 2/10, n/30.
- 27 Paid Cosmo Distributors in full, less discount.
- 29 Made refunds to cash customers for defective merchandise \$60. The returned merchandise had a scrap value of \$10.
- 31 Sold merchandise on account \$900, terms n/30. The cost of the merchandise sold was \$560.

Newman Hardware's chart of accounts includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 126 Supplies, No. 201 Accounts Payable, No. 301 Newman, Capital, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 414 Sales Discounts, No. 505 Cost of Goods Sold.

### Instructions

- (a) Journalize the transactions using a perpetual inventory system.
- (b) Enter the beginning cash and capital balances and post the transactions. (Use J1 for the journal reference.)
- (c) Prepare an income statement through gross profit for the month of May 2010.

(c) Gross profit \$2,269

*Prepare financial statements and adjusting and closing entries.*

(SO 4, 5)

**P5-3B** Tarp Department Store is located in midtown Platteville. During the past several years, net income has been declining because of suburban shopping centers. At the end of the company's fiscal year on November 30, 2010, the following accounts appeared in two of its trial balances.

	<u>Unadjusted</u>	<u>Adjusted</u>		<u>Unadjusted</u>	<u>Adjusted</u>
Accounts Payable	\$ 25,200	\$ 25,200	Interest Revenue	\$ 8,000	\$ 8,000
Accounts Receivable	30,500	30,500	Merchandise Inventory	29,000	29,000
Accumulated Depr.—Delivery Equip.	10,000	15,000	Notes Payable	37,000	37,000
Accumulated Depr.—Store Equip.	24,000	32,000	Prepaid Insurance	10,500	3,500
Cash	6,000	6,000	Property Tax Expense		2,800
J. Tarp, Capital	101,700	101,700	Property Taxes Payable		2,800
Cost of Goods Sold	507,000	507,000	Rent Expense	15,000	15,000
Delivery Expense	6,500	6,500	Salaries Expense	96,000	96,000
Delivery Equipment	46,000	46,000	Sales	680,000	680,000
Depr. Expense—Delivery Equip.		5,000	Sales Commissions Expense	6,500	11,200
Depr. Expense—Store Equip.		8,000	Sales Commissions Payable		4,700
J. Tarp, Drawing	10,000	10,000	Sales Returns and Allowances	8,000	8,000
Insurance Expense		7,000	Store Equip.	100,000	100,000
Interest Expense	6,400	6,400	Utilities Expense	8,500	8,500

### Instructions

- Prepare a multiple-step income statement, an owner's equity statement, and a classified balance sheet. Notes payable are due in 2013.
- Journalize the adjusting entries that were made.
- Journalize the closing entries that are necessary.

(a) Net income \$6,600  
Capital \$98,300  
Total assets \$168,000

**P5-4B** Caleb Borke, a former disc golf star, operates Caleb's Discorama. At the beginning of the current season on April 1, the ledger of Caleb's Discorama showed Cash \$1,800, Merchandise Inventory \$2,500, and C. Borke, Capital \$4,300. The following transactions were completed during April.

Journalize, post, and prepare a trial balance.

(SO 2, 3, 4)



- Apr. 5 Purchased golf discs, bags, and other inventory on account from Innova Co. \$1,200, FOB shipping point, terms 2/10, n/60.
- 7 Paid freight on Innova's purchase \$50.
- 9 Received credit from Innova Co. for merchandise returned \$100.
- 10 Sold merchandise on account for \$900, terms n/30. The merchandise sold had a cost of \$540.
- 12 Purchased disc golf shirts and other accessories on account from Lightning Sportswear \$670, terms 1/10, n/30.
- 14 Paid Innova Co. in full, less discount.
- 17 Received credit from Lightning Sportswear for merchandise returned \$70.
- 20 Made sales on account for \$560, terms n/30. The cost of the merchandise sold was \$340.
- 21 Paid Lightning Sportswear in full, less discount.
- 27 Granted an allowance to members for clothing that was flawed \$30.
- 30 Received payments on account from customers \$800.

The chart of accounts for the store includes the following: No. 101 Cash, No. 112 Accounts Receivable, No. 120 Merchandise Inventory, No. 201 Accounts Payable, No. 301 C. Borke, Capital, No. 401 Sales, No. 412 Sales Returns and Allowances, No. 505 Cost of Goods Sold.

### Instructions

- Journalize the April transactions using a perpetual inventory system.
- Enter the beginning balances in the ledger accounts and post the April transactions. (Use J1 for the journal reference.)
- Prepare a trial balance on April 30, 2010.

(c) Total debits \$5,760

**\*P5-5B** At the end of Duckworth Department Store's fiscal year on November 30, 2010, these accounts appeared in its adjusted trial balance.

Determine cost of goods sold and gross profit under periodic approach.

(SO 6, 7)

Freight-in	\$ 4,500
Merchandise Inventory	40,000
Purchases	585,000
Purchase Discounts	6,300
Purchase Returns and Allowances	2,700
Sales	810,000
Sales Returns and Allowances	18,000



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Additional facts:

1. Merchandise inventory on November 30, 2010, is \$32,600.
2. Note that Duckworth Department Store uses a periodic system.

### Instructions

Prepare an income statement through gross profit for the year ended November 30, 2010.

Gross profit \$204,100

Calculate missing amounts and assess profitability.

(SO 6, 7)

**\*P5-6B** Letterman Inc. operates a retail operation that purchases and sells home entertainment products. The company purchases all merchandise inventory on credit and uses a periodic inventory system. The accounts payable account is used for recording inventory purchases only; all other current liabilities are accrued in separate accounts. You are provided with the following selected information for the fiscal years 2007 through 2010, inclusive.

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
<b><u>Income Statement Data</u></b>				
Sales		\$53,300	\$ (e)	\$45,200
Cost of goods sold		(a)	13,800	14,300
Gross profit		38,300	33,800	(i)
Operating expenses		34,900	(f)	28,600
Net income		\$ (b)	\$ 2,500	\$ (j)
<b><u>Balance Sheet Data</u></b>				
Merchandise inventory	\$7,200	\$ (c)	\$8,100	\$ (k)
Accounts payable	3,200	3,600	2,500	(l)
<b><u>Additional Information</u></b>				
Purchases of merchandise inventory on account		\$14,200	\$ (g)	\$13,200
Cash payments to suppliers		(d)	(h)	13,600

### Instructions

- (a) Calculate the missing amounts.
- (b) Sales declined over the 3-year fiscal period, 2008–2010. Does that mean that profitability necessarily also declined? Explain, computing the gross profit rate and the profit margin ratio for each fiscal year to help support your answer. (Round to one decimal place.)

(c) \$6,400

(g) \$15,500

(i) \$30,900

Journalize, post, and prepare trial balance and partial income statement using periodic approach.

(SO 7)



**\*P5-7B** At the beginning of the current season on April 1, the ledger of Five Pines Pro Shop showed Cash \$3,000; Merchandise Inventory \$4,000; and Irene Tiger, Capital \$7,000. These transactions occurred during April 2010.

- Apr. 5 Purchased golf bags, clubs, and balls on account from Mickelson Co. \$1,200, FOB shipping point, terms 2/10, n/60.
- 7 Paid freight on Mickelson Co. purchases \$50.
- 9 Received credit from Mickelson Co. for merchandise returned \$100.
- 10 Sold merchandise on account to members \$600, terms n/30.
- 12 Purchased golf shoes, sweaters, and other accessories on account from Dagger Sportswear \$340, terms 1/10, n/30.
- 14 Paid Mickelson Co. in full.
- 17 Received credit from Dagger Sportswear for merchandise returned \$40.
- 20 Made sales on account to members \$600, terms n/30.
- 21 Paid Dagger Sportswear in full.
- 27 Granted credit to members for clothing that had flaws \$35.
- 30 Received payments on account from members \$650.

The chart of accounts for the pro shop includes Cash; Accounts Receivable; Merchandise Inventory; Accounts Payable; Irene Tiger, Capital; Sales; Sales Returns and Allowances; Purchases; Purchase Returns and Allowances; Purchase Discounts, and Freight-in.

### Instructions

- (a) Journalize the April transactions using a periodic inventory system.
- (b) Using T accounts, enter the beginning balances in the ledger accounts and post the April transactions.
- (c) Prepare a trial balance on April 30, 2010.
- (d) Prepare an income statement through gross profit, assuming merchandise inventory on hand at April 30 is \$4,726.

(c) Tot. trial balance \$8,365  
Gross profit \$466

## PROBLEMS: SET C



Visit the book's companion website at [www.wiley.com/college/veygandt](http://www.wiley.com/college/veygandt), and choose the Student Companion site, to access Problem Set C.

## CONTINUING COOKIE CHRONICLE

(Note: This is a continuation of the Cookie Chronicle from Chapters 1 through 4.)

**CCC5** Because Natalie has had such a successful first few months, she is considering other opportunities to develop her business. One opportunity is the sale of fine European mixers. The owner of Kzinski Supply Company has approached Natalie to become the exclusive U.S. distributor of these fine mixers in her state. The current cost of a mixer is approximately \$525 (U.S.), and Natalie would sell each one for \$1,050. Natalie comes to you for advice on how to account for these mixers.



Go to the book's companion website,  
[www.wiley.com/college/veygandt](http://www.wiley.com/college/veygandt),  
to see the completion of this problem.

# BROADENING YOUR PERSPECTIVE

## FINANCIAL REPORTING AND ANALYSIS

### Financial Reporting Problem: PepsiCo, Inc.

**BYP5-1** The financial statements of **PepsiCo, Inc.** are presented in Appendix A at the end of this textbook.



#### Instructions

Answer the following questions using PepsiCo's Consolidated Statement of Income.

- What was the percentage change in (1) sales and in (2) net income from 2005 to 2006 and from 2006 to 2007?
- What was the company's gross profit rate in 2005, 2006, and 2007?
- What was the company's percentage of net income to net sales in 2005, 2006, and 2007? Comment on any trend in this percentage.

### Comparative Analysis Problem: PepsiCo, Inc. vs. The Coca-Cola Company

**BYP5-2** PepsiCo's financial statements are presented in Appendix A. Financial statements of **The Coca-Cola Company** are presented in Appendix B.



#### Instructions

- Based on the information contained in these financial statements, determine each of the following for each company.
  - Gross profit for 2007.
  - Gross profit rate for 2007.
  - Operating income for 2007.
  - Percent change in operating income from 2006 to 2007.
- What conclusions concerning the relative profitability of the two companies can you draw from these data?



## Exploring the Web

**BYP5-3** No financial decision maker should ever rely solely on the financial information reported in the annual report to make decisions. It is important to keep abreast of financial news. This activity demonstrates how to search for financial news on the Web.

**Address:** [biz.yahoo.com/i](http://biz.yahoo.com/i), or go to [www.wiley.com/college/wegandt](http://www.wiley.com/college/wegandt)

### Steps:

1. Type in either PepsiCo or Coca-Cola.
2. Choose **News**.
3. Select an article that sounds interesting to you.

### Instructions

- (a) What was the source of the article? (For example, Reuters, Businesswire, PR Newswire.)
- (b) Pretend that you are a personal financial planner and that one of your clients owns stock in the company. Write a brief memo to your client, summarizing the article and explaining the implications of the article for their investment.

## CRITICAL THINKING



## Decision Making Across the Organization

**BYP5-4** Three years ago, Carrie Dungy and her brother-in-law Luke Barber opened FedCo Department Store. For the first two years, business was good, but the following condensed income results for 2009 were disappointing.

FEDCO DEPARTMENT STORE		
Income Statement		
For the Year Ended December 31, 2009		
Net sales		\$700,000
Cost of goods sold		<u>553,000</u>
Gross profit		147,000
Operating expenses		
Selling expenses	\$100,000	
Administrative expenses	<u>20,000</u>	<u>120,000</u>
Net income		<u>\$ 27,000</u>

Carrie believes the problem lies in the relatively low gross profit rate (gross profit divided by net sales) of 21%. Luke believes the problem is that operating expenses are too high.

Carrie thinks the gross profit rate can be improved by making both of the following changes. She does not anticipate that these changes will have any effect on operating expenses.

1. Increase average selling prices by 17%. This increase is expected to lower sales volume so that total sales will increase only 6%.
2. Buy merchandise in larger quantities and take all purchase discounts. These changes are expected to increase the gross profit rate by 3 percentage points.

Luke thinks expenses can be cut by making both of the following changes. He feels that these changes will not have any effect on net sales.

1. Cut 2009 sales salaries of \$60,000 in half and give sales personnel a commission of 2% of net sales.
2. Reduce store deliveries to one day per week rather than twice a week; this change will reduce 2009 delivery expenses of \$30,000 by 40%.

Carrie and Luke come to you for help in deciding the best way to improve net income.

**Instructions**

With the class divided into groups, answer the following.

- (a) Prepare a condensed income statement for 2010 assuming (1) Carrie's changes are implemented and (2) Luke's ideas are adopted.
- (b) What is your recommendation to Carrie and Luke?
- (c) Prepare a condensed income statement for 2010 assuming both sets of proposed changes are made.

## Communication Activity

**BYP5-5** The following situation is in chronological order.

1. Flutie decides to buy a surfboard.
2. He calls Surfing USA Co. to inquire about their surfboards.
3. Two days later he requests Surfing USA Co. to make him a surfboard.
4. Three days later, Surfing USA Co. sends him a purchase order to fill out.
5. He sends back the purchase order.
6. Surfing USA Co. receives the completed purchase order.
7. Surfing USA Co. completes the surfboard.
8. Flutie picks up the surfboard.
9. Surfing USA Co. bills Flutie.
10. Surfing USA Co. receives payment from Flutie.

**Instructions**

In a memo to the president of Surfing USA Co., answer the following.

- (a) When should Surfing USA Co. record the sale?
- (b) Suppose that with his purchase order, Flutie is required to make a down payment. Would that change your answer?

## Ethics Case

**BYP5-6** Laura McAntee was just hired as the assistant treasurer of Dorchester Stores. The company is a specialty chain store with nine retail stores concentrated in one metropolitan area. Among other things, the payment of all invoices is centralized in one of the departments Laura will manage. Her primary responsibility is to maintain the company's high credit rating by paying all bills when due and to take advantage of all cash discounts.

Danny Feeney, the former assistant treasurer who has been promoted to treasurer, is training Laura in her new duties. He instructs Laura that she is to continue the practice of preparing all checks "net of discount" and dating the checks the last day of the discount period. "But," Danny continues, "we always hold the checks at least 4 days beyond the discount period before mailing them. That way we get another 4 days of interest on our money. Most of our creditors need our business and don't complain. And, if they scream about our missing the discount period, we blame it on the mail room or the post office. We've only lost one discount out of every hundred we take that way. I think everybody does it. By the way, welcome to our team!"

**Instructions**

- (a) What are the ethical considerations in this case?
- (b) Who are the stakeholders that are harmed or benefitted in this situation?
- (c) Should Laura continue the practice started by Danny? Does she have any choice?

## "All About You" Activity

**BYP5-7** There are many situations in business where it is difficult to determine the proper period in which to record revenue. Suppose that after graduation with a degree in finance, you take a job as a manager at a consumer electronics store called Atlantis Electronics. The company has expanded rapidly in order to compete with **Best Buy** and **Circuit City**. Atlantis has also begun selling gift cards for its electronic products. The cards are available in any dollar amount, and allow the holder of the card to purchase an item for up to 2 years from the time the card is purchased. If the card is not used during that 2 years, it expires.



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### Instructions

Answer the following questions: At what point should the revenue from the gift cards be recognized? Should the revenue be recognized at the time the card is sold, or should it be recorded when the card is redeemed? Explain the reasoning to support your conclusion.



### Answers to Insight and Accounting Across the Organization Questions

#### p. 203 Morrow Snowboards Improves Its Stock Appeal

Q: If a perpetual system keeps track of inventory on a daily basis, why do companies ever need to do a physical count?

A: *A perpetual system keeps track of all sales and purchases on a continuous basis. This provides a constant record of the number of units in the inventory. However, if employees make errors in recording sales or purchases or shrinkage occurs because of fraud and waste, the inventory value will not be correct. Thus, all companies do a physical count of inventory at least once a year.*

#### p. 210 Should Publishers Have Liberal Return Policies?

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

A: *If a company expects significant returns, it should make an adjusting entry at the end of the year reducing sales by the estimated amount of sales returns. This is necessary to avoid overstating the amount of revenue recognized in the period.*

### Answers to Self-Study Questions

1. c   2. a   3. c   4. b   5. c   6. c   7. a   8. d   9. b   10. c   11. d   \*12. d   \*13. a  
\*14. b   \*15. a