# Special Issues for Merchants

## Part 1

Your goals for this “merchandising” chapter are to learn about:

- Merchandising businesses and related sales recognition issues.
- Purchase recognition issues for the merchandising business.
- Alternative inventory system: The perpetual method.
- Enhancements of the income statement.
- The control structure.

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# 1. The Merchandising Operation - Sales

The discussion and illustrations in the earlier chapters were all based on businesses that generate their revenues by providing services (like law firms, lawn services, architects, etc.). Service businesses are a large component of an advanced economy. However, we also spend a lot of time in the stores or on the internet, buying the things we want or need. Such businesses are generally referred to as “merchants,” and their business models are generally based upon purchasing inventory and reselling it at a higher price to customers.

Therefore, this chapter shifts focus from the service business to the merchandising business. Measuring income and reporting it on the income statement involves unique considerations. The most obvious issue is the computation and presentation of an amount called “gross profit.” Gross profit is the difference between sales and cost of goods sold, and is reported on the income statement as an intermediate amount. Observe the income statement for Chair Depot below. The gross profit number indicates that the company is selling merchandise for more than cost ($200,000 in sales was generated from goods that cost $120,000 to buy). Of course, the company also incurred other operating expenses; advertising, salaries, and rent. Nevertheless, the gross profit was sufficient to easily cover those costs and leave a tidy profit to boot. The presentation of the gross profit information is very important for users of the financial statements to get a clear picture of operating success. Obviously, if the gross profit rate is small, the business might have trouble making a profit, even if sales improved. Quite the reverse is true if the gross profit rate is strong; improved sales can markedly improve the bottom-line net income (especially if operating expenses like rent, etc., don’t change with increases in sales)! It is easy to see why separating the gross profit number from the other income statement components is an important part of reporting for the merchandising operation.

| CHAIR DEPOT<br>Income Statement<br>For the Year Ending December 31, 20X3 | | |
|---|---|---|
| Sales | | $200,000 |
| Cost of goods sold | | 120,000 |
| Gross profit | | $ 80,000 |
| Expenses | | |
| Advertising | $ 6,000 | |
| Salaries | 9,000 | |
| Rent | 5,000 | 20,000 |
| Net income | | $ 60,000 |

## 1.1 Sales

The Sales account is a revenue account used strictly for sales of merchandise. Sales are initially recorded via one of the following entries, depending on whether the sale is for cash or on account:

Cash sale:

| | | | |
|---|---|---|---|
| 1-5-X5 | Cash | 4,000 | |
| | Sales | | 4,000 |
| | *Sold merchandise for cash* | | |

Sale on account:

| | | | |
|---|---|---|---|
| 1-5-X5 | Accounts Receivable | 4,000 | |
| | Sales | | 4,000 |
| | *Sold merchandise on account* | | |

## 1.2 Sales Returns and Allowances

Occasionally, a customer returns merchandise. When that occurs, the following entry should be made:

| | | | |
|---|---|---|---|
| 1-9-X5 | Sales Returns and Allowances | 1,000 | |
| | Accounts Receivable | | 1,000 |
| | *Customer returned merchandise previously purchased on account* | | |

Notice that the above entry included a debit to Sales returns and allowances (rather than canceling the sale). The Sales returns and allowances account is a contra-revenue account that is deducted from sales; sales less sales returns and allowances is sometimes called "net sales." This approach is deemed superior because it allows interested parties to easily track the level of sales returns in relation to overall sales. Importantly, this presentation reveals information about the relative level of returns and provides a measure of customer satisfaction or dissatisfaction. Sales returns (on account) are typically documented by the creation of an instrument known as a credit memorandum. The credit memorandum indicates that a customer's account receivable balance has been credited (reduced), and that payment for the returned goods is

CHAIR DEPOT
Income Statement
For the Year Ending December 31, 20X3

| | |
|---|---|
| Sales | $200,000 |
| Less: Sales returns and allowances | 10,000 |
| Net sales | $190,000 |
| Cost of goods sold | 114,000 |
| Gross profit | $ 76,000 |
| ⋮ | ⋮ |

NET SALES

not expected. If the preceding transaction involved a cash refund, the only difference in the entry would involve a credit to cash instead of accounts receivable. The calculation of net sales would be unaffected.

Note that use of the word "allowances" in the account title "Sales Returns and Allowances." What is the difference between a return and an allowance? Perhaps a customer's reason for wishing to return an item is because of a minor defect; they may be willing to keep the item if the price is slightly reduced. The merchant may give them an allowance (e.g., a reduction in the price they previously agreed to) to induce them not to return the item. The entry to record an allowance would be identical to that above for the agreed amount of the price reduction, and the customer would keep the inventory item. (Of course, one could use a separate account for returns and another for allowances if they wished to track information about each of these elements.)

## 1.3 Trade Discounts

Product catalogs often provide a "list price" for an item. Oftentimes those list prices bear little relation to the actual selling price. A merchant may offer customers a trade discount that involves a reduction from the catalog or list price. Ultimately, the purchaser is responsible for the invoice price, that is, the list price less the applicable trade discount. Trade discounts are not entered in the accounting records. They are not considered to be a part of the sale because the exchange agreement was based on the reduced price level. Remember the general rule: sales are recorded when an exchange takes place, based on the exchange price. Therefore, the amount recorded as a sale is the invoice price. The entries above (for the $4,000 sale) would still be appropriate if the list price was $5,000, subject to a 20% trade discount.

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## 1.4 Credit Cards

In the retail trade, merchants often issue credit cards. Why? Because they induce people to spend, and interest charges that may be assessed can themselves provide a generous source of additional profit. However, these company issued cards introduce many added costs: customers that don't pay (known as bad debts), maintenance of a credit department, periodic billings, and so forth. To avoid the latter, many merchants accept other forms of credit cards like American Express, Master Card, and so forth. When a merchant accepts these cards, they are usually paid instantly by the credit card company (net of a service charge that is negotiated in the general range of 1% to 3% of the sale). The subsequent billing and collection is handled by the credit card company. Many merchants will record the full amount of the sale as revenue, and then recognize an offsetting expense for the amount charged by the credit card companies.

## 1.5 Cash Discounts

Merchants often sell to other businesses. For example, assume that Barber Shop Supply sells equipment to various barber shops on open account (i.e., a standing agreement to extend credit for purchases). In these settings, the seller would like to be paid promptly after billing, and may encourage prompt payment by offering a cash discount (also known as a sales discount).

There is a catch, though. To receive the cash discount, the buyer must pay the invoice promptly. The amount of time one has available to pay is expressed in a unique manner, such as 2/10, n/30 -- these terms mean that a 2% discount is available if the invoice is paid within 10 days, otherwise, the net amount is expected to be paid within 30 days. Assume that Barber Shop Supply sold goods for $1,000, subject to terms of 2/10, n/ 30. The following entry would be recorded at the time of sale:

| | | | | |
|---|---|---|---|---|
| 5-11-X4 | Accounts Receivable | | 1,000 | |
| | Sales | | | 1,000 |
| | *Sold merchandise on account, terms 2/10, n/30* | | | |

The invoice that would be issued by Barber Shop Supply is illustrated on the next page. Take special note of the invoice date, terms, and invoice amount.

BARBER SHOP SUPPLY
987 Industrial Blvd.
Chicago, IL 12345

Invoice #88765

BILL TO: Tomas Mueller
Hair Port Landing
111 Style Lane, Suite 15
Dallas, TX 99889

DATE

TERMS

| P.O. NUMBER | INVOICE DATE | F.O.B. POINT | TERMS |
|---|---|---|---|
| 66554f8 | MAY 11, 20X4 | Dallas | 2/10,n/30 |

| QTY. | PART # | DESCRIPTION | UNIT PRICE | TOTAL |
|---|---|---|---|---|
| 4 | A7786 | Full Length Mirrors | $ 90 | $ 360 |
| 1 | C8876 | Swivel Chair -- Brown Leather | 500 | 500 |
| 1 | M8776 | Barber Pole Motor and Light Kit | 140 | 140 |
| | | THANK YOU FOR YOUR BUSINESS! | | |
| | | | Subtotal | $1,000 |
| | | | Sales Tax | - |
| | | | Shipping and Handling | - |
| | | | Other | - |
| | | | TOTAL | $1,000 |

AMOUNT

If Hair port landing pays the invoice in time to receive the discount, the check below for $980 would be received by Barber Shop Supply, and recorded via the following entry. This entry reflects that the customer took advantage of the discount terms by paying within the 10-day window. Notice that the entry reduces accounts receivable for the full invoice amount because the payment satisfied the total obligation. The discount is recognized in a special Sales Discount account. The discount account would be reported in like manner to the Sales Returns and Allowance account presented earlier in this chapter.

Hair Port Landing
111 Style Lane, Suite 15
Dallas, TX 99889

Date: May 19, 20X4

Pay to the order of: BARBER SHOP SUPPLY $980.00

********* NINE-HUNDRED EIGHTY AND NO/100 DOLLARS **********************

1st CORNER BANK

MEMO Invoice #88765

Tomas Mueller

| | | | |
|---|---|---|---|
| 5-19-X4 | Cash | 980 | |
| | Sales Discounts | 20 | |
| | Accounts Receivable | | 1,000 |
| | *Collected outstanding receivable within discount period, 2% discount granted* | | |

If the customer pays too late to get the discount, then the payment received should be for the full invoice amount, and it would be recorded as follows:

| | | | |
|---|---|---|---|
| 5-29-X4 | Cash | 1,000 | |
| | Accounts Receivable | | 1,000 |
| | *Collected outstanding receivable outside of the discount period* | | |

Having looked at several of the important and unique issues for recognizing sales transactions of merchandising businesses, it is now time to turn to the accounting for purchasing activities.

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