**Accounting – 6:11**

Merchandising Operations Cont.

Accounting for Inventory

Think about analyzing these transactions as you review which accounts are associated with merchandising operations.

1. Recording of purchases under Perpetual Inventory system.

**Debit** Merchandise Inventory (Asset)

**Credit** Cash or Accounts Payable

1. Purchase Returns – are for goods which are damaged, defective, or of inferior quality and which may be returned.

**Debit** Accounts Payable or cash

**Credit** Merchandise Inventory

1. Purchase Allowance – the purchaser may choose to keep the goods which are damaged, defective, or of inferior quality provided the seller will grant a discount or allowance

**Debit** A/P or cash

**Credit** Merchandise Inventory

1. Freight Costs – Freight-in costs are the cost of transporting the goods for purchase.

Freight-in is recorded:

**Debit** Merchandise Inventory

**Credit** Cash or Accounts Payable

1. Freight-Out – Freight costs incurred by the seller on outgoing merchandise are an operating expense to the seller.

Freight-out is recorded:

**Debit** Freight-out

**Credit** Cash or A/P

1. Purchase Discount – Credit terms are normally written 2/10, n/30 which means a 2 percent purchase discount may be taken if the invoice is paid within 10 days of the invoice date. Net amount of the invoice is due within 30 days. Purchase discounts reduce the cost of goods purchased. Similarly, sales discounts reduce the revenue of goods sold.
2. Sales Discount – The seller may offer the customer a sales discount for the prompt payment. A sales discount is usually based on the invoice price less any returns and allowances. Sales Discounts is a contra revenue account to sales. (debit balance)

**Debit** Sales Discount

**Debit** Cash

**Credit** Accounts Receivable

1. Sales Returns and Allowances is a contra revenue account to Sales. It may be used to record the return of goods. Two entries are required to record the return.

1st – **Debit** Sales Returns and Allowances

**Credit** Accounts Receivable

2nd – **Debit** Merchandise Inventory

**Credit** Cost of Goods Sold

1. Both the purchase and sales of merchandising inventory can be done for cash or credit. Depending on which method of purchase/sale is used merchandising transactions can get somewhat complicated.
2. A simple cash sale of merchandise would be recorded as a debit to cash and a credit to sales revenue. A simple credit sale of merchandise would likewise be recorded as a debit to a receivable and a credit to sales revenue.
3. However, this is only half of the transaction when dealing with merchandise. We are required to record the cost of the goods we sold and to reduce our inventory by the amount that we sold. To do this we record the cost of goods by debiting the Cost of Goods Sold Expense and reduce inventory by crediting the Merchandise Inventory account by the cost of merchandise sold.
4. Cash Sales

**Debit** Cash

**Credit** Sales (Revenue acct)

**Debit** Cost of Goods Sold

**Credit** Merchandise Inventory

1. Credit Sales

**Debit** Accounts Receivable

**Credit** Sales (Revenue)

**Debit** Cost of Goods Sold

**Credit** Merchandise Inventory

1. Inventory Costing (think about analyzing the following)
2. **Purchases** of inventory **increases an asset**
   1. Are often paid for on account (a liability), by cash, or by a combination of the two
3. Inventory accounting methods include
   1. **FIFO** – First in First out. This method builds layers and says that the oldest (first) inventory you purchased is the first sold (out).
   2. **LIFO** – Last in First out. This method builds layers and says that the latest (newest) inventory is the first to be sold (out).
4. Who cares?
   * 1. Because the cost to you of your inventory most likely changes over time the choice of **FIFO/LIFO can affect your profit calculation.**
5. How?
   * 1. Assume you have two widgets in inventory. The first was purchased last year for $1,000 and the second this year for $1,500. If you sell the widget for $2,000 this year then you receive $2,000 and the cost of what you sell would be $\_\_\_\_\_\_\_ under LIFO of $\_\_\_\_\_\_\_\_ under FIFO. Thus your profit under LIFO is $\_\_\_\_\_\_\_\_\_ vs. $\_\_\_\_\_\_\_ under FIFO.
6. Merchandising Operations must determine **Cost of Goods Sold,** for example, under the periodic method:

Beginning Inventory

+ Purchases

- Purchase returns

- Purchase discounts

+ Freight in .

= Cost of Goods available for sale

- Ending Inventory .

= **Cost of Goods Sold**

**Accounting – 7:**

Receivables & Bad Debt

* + - 1. **Accounts Receivable –** are amounts owed by customers often resulting from the sale of goods or the provision of services.
      2. **Notes Receivable –** result from sale of goods and services and are a form of formal promissory (credit) note requiring the payment of interest.

Notes or accounts receivables that result from sales transactions are often called trade receivables.

* + - 1. **Recognition of A/R –** Merchandisers record accounts receivable at the point of sale of merchandise on account:

**Debit** A/R

**Credit** Sales

* + - 1. **Valuing A/R –** To avoid overstating receivables on the balance sheet, they are stated at their cash (net) realizable value. (NRV)

Bad Debt expense – arises from A/R that are estimated as uncollectible. Bad Debt Expense is reported as a **selling expense** in the income statement. There are two methods used in accounting for uncollectible accounts, 1) Direct Write-off Method (not GAAP), & 2) The Allowance Method (required by GAAP) which we’ll focus on.

* + - 1. **The allowance method** is carried out by estimating uncollectible A/R, using either percentage of sales or percentage of A/R, and matching this against sales (revenue) in the same accounting period in which the sales occurred:
      2. **Percent of receivables** is done by – Estimating the desired ending balance in the allowance for doubtful accounts then adjusting **Bad Debt expense** and the **Allowance for Doubtful Accounts** to achieve the desired ending allowance balance. (The Allowance for Doubtful Accounts is a contra-asset account.)
      3. **Estimated uncollectibles** (estimated by either % of sales or % of receivables) are recorded as

**Debit** Bad debt expense

**Credit** Allowance for doubtful account

* + - 1. Writing off of a bad account is done by a

**Debit** Allowance for Doubtful Accounts

**Credit** A/R

* + - 1. Collection of an account previously written off

**Debit** A/R

**Credit** Allowance for Doubtful Accounts

**Debit** Cash

**Credit** A/R

**Accounting – 8:**

Prepaid Expenses & Unearned Revenue

1. Prepayments – These often expire over time and with the expiration an expense is incurred. **Adjusting entries for prepaid accounts will decrease a balance sheet account and increase an income statement account.**

* Prepaid expenses adjustments show they have expired with the passage of time or they have been consumed (e.g. supplies).

Original Entry: (made previously)

**Debit** Asset Account

**Credit** Cash

Adjusting entry for prepaid expenses

**Debit** expense account (show usage)

**Credit** asset account (prepaid account)

1. Unearned Revenue – These are recorded when money is received for goods or services that have yet to be provided or delivered. This creates a liability until the obligation is fulfilled.

**Adjusting entries for unearned revenues will decrease a balance sheet account and increase an income statement account.**

* Unearned revenues adjustments show unearned revenues are now earned.

Original Entry: (made previously)

**Debit** Cash

**Credit** Liability (unearned revenue)

Adjusting entry to show revenue is now earned

**Debit** Liability (unearned revenue)

**Credit** Revenue

**Accounting – 9:**

Property, Plant, and Equipment & Depreciation

1. Property, Plant, and Equipment (PP&E) is also referred to as fixed assets, plant assets, or long-lived assets. This includes the various assets used by a company to carry out its operations and are not held for resale.
2. Equipment and Buildings (assets) are recorded **at cost plus any other charges** incurred to acquire and make them ready for use (e.g., shipping &set-up costs). These costs are thus “capitalized” and not expensed. (See Depreciation). Building costs are debited to the building account and equipment costs are debited to the respective equipment accounts.
3. Land, purchased for carrying out operations, is classified as a plant asset. If land is purchased for development or resale it is classified as inventory. The cost of land includes the purchase price and all costs necessary to make it ready for use (e.g., clearing and draining costs, and attorney and title fees).
4. Examples:

**Debit** Machine

**Credit** Cash

(Purchase a machine for cash and set it up)

**Debit** Building

**Credit** Materials

**Credit** Wages…etc. for as many accounts as needed.

(Construct our own building)

**Debit** Land

**Credit** Mortgage Payable

**Credit** Cash

(Purchase land paying some cash down & taking a mortgage)

1. Depreciation
   1. This is the process of **allocating** an assets **cost over the period** of time that it is **used.**
   2. **Terms:** Cost/Salvage Value / Depreciable Value / Useful Life
      1. Cost –historical cost of the asset.
      2. Salvage value—an estimate of the asset’s value at the end of its useful life.
      3. Depreciable Value—the cost less salvage value.
      4. Useful life—estimate of the useful life.
   3. Each period there will be a **depreciation expense** that reflects the loss in value of an asset due to its use in that period.
   4. Depreciation is recorded in a balance sheet account that accumulates the total accounting loss in value due to use. This is the **ACCUMULATED DEPRECIATION**  account and is a **‘contra asset’** account. Its **normal balance is a Cr.**
   5. Common methods of depreciation:
      1. Straight-line –equal amount each year for the estimated useful life
      2. Double-Declining Balance – (1/useful life) \* 2
   6. Who cares?
      1. The method of depreciation affects the expense that is recorded in a period and thus offsets revenue in calculating Net Income.

**Debit** Dep. Expense

**Credit** Acc. Depreciation

1. The assets’ total value is reported ‘net of’ depreciation:

Carrying Value (purchase price + other set up costs)

- Accumulated Depreciation

= Net Book Value

**Accounting – 10:**

Liabilities & Equity

1. Liabilities
   1. The sources of funds used to acquire assets are (1) Liabilities and (2) equity.
   2. Liabilities are owed to creditors.
   3. Liabilities reduce the value of EQUITY, a residual claim, when we net them against assets.
   4. Liabilities have a natural credit balance.
   5. A contra account used to reduce a liability would have a debit balance.
   6. Liabilities for expenses incurred but not yet paid are called **accrued liabilities,** such as wages payable. **Failing to record one of these would result in overstated net income.** (Can you explain why?)
2. Current Liabilities
   1. Consistent with the definition of current assets, current liabilities are claims that become due within one year. Most companies pay current liabilities out of current assets.
      1. For example, amounts owed to employees and others for services they have provided but for which they have not been paid are listed as accrued liabilities.
3. Long term Liabilities
   1. Consistent with the definition of long term assets, long term liabilities reclaims that become due in more than a year.
   2. We often have to pay an interest expense when we have liabilities.
      1. The amount of **interest we owe is a period expense** (cost) we pay for the benefit of the liability. For example, the interest we pay on a loan for being able to borrow the money.
4. Equity
   1. Equity consists of **capital** obtained from **sources** they are **not liabilities**, e.g., stocks rather than bonds.
   2. Paid-in Capital: is the amount of capital supplied by equity investors.

These people own the company

* 1. Paid-in capital is reported in two parts: “Common Stock” and “Additional Paid-in Capital”.
     1. Additional Paid-in Capital = cash paid – par value of common stock.

**Accounting – 11:**

The Statement of Cash Flows

1. The Primary Purpose of the Statement of Cash Flows is to provide information about cash receipts, cash payments, and the net change in cash resulting from **operating, investing, and financing activities** of a company during a period.
2. Statement of Cash Flows can help answer questions such as, How did cash increase when there was a net loss for the period? How were the proceeds of the bond issue used? Why were dividends not increased? How much money was borrowed during the year? And Is cash flow greater or less than net income?
3. Primary sources of information for the Statement of Cash Flows are comparative balance sheets, the current income statement, and additional other information.
4. For purposes of the Statement of Cash Flows cash receipts and disbursements are classified as either:
5. **Operating activities**
6. **Investing activities**
7. **Financing Activities**
8. **Operating Activities** include the cash portion of transactions that create revenues and expenses and enter into determination of net income. Some cash flows relating to investing or financing activities are classified as operating activities. For example, receipts of investment interest and dividends and payments of interest to lenders are classified as operating activities because these items are reported in the income statement. For example, inflows would include cash from sale of goods or services and interest received on loans and equity dividends while outflows would include cash paid to suppliers, employees, lenders, and the government.
9. **Investing Activities** include the cash portion of transactions for purchasing and disposing of investments and productive long-lived assets, using cash and lending money, and collecting the loans. For example, inflows would include cash from sales of property, plant, and equipment and sale of debt or equity securities, and collection of principal on loans while outflows would include cash to purchase property, plant, and equipment, to purchase debt or equity securities of other entities, and to make loans to other entities.
10. **Financing Activities** include the cash portion of transactions for issuing debt and repaying the amounts borrowed and obtaining cash from stockholders and paying dividends. For example, inflows would include cash from sale of company’s own stock or issuance of bonds while outflows would include cash paid as dividends or to redeem long-term debt or reacquire company stock.
11. Format of the Statement of Cash Flows lists three activities:

Operating

Investing

Financing

PLUS

Non-cash investing and financing activities

1. The Direct method for converting net income from an accrual basis to a cash basis adjusts each item in the income statement from the accrual basis to the cash basis. Begin by analyzing the revenues and expenses reported in the income statement in the order in which they are reported and then determine the cash receipts and payments related to these revenues and expenses.