Chapter 5 — Accounting for Merchandising Operations

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1 · Merchandising operations

Up to now the businesses in this course have sold services. A merchandiser is different: it buys goods and resells them. That one change adds a big new number to the income statement — the cost of the goods sold — and a new headline figure, gross profit.

Cost of goods sold (COGS): The total cost of the merchandise a company sold during the period. It is the merchandiser's largest expense.

Gross profit: Net sales minus cost of goods sold. It's what's left from sales to cover operating expenses and leave a profit.

The whole chapter follows one chain: Net sales - Cost of goods sold = Gross profit; Gross profit - Operating expenses = Net income. A merchandiser's operating cycle is also longer than a service firm's — it runs cash -> buy inventory -> sell inventory -> collect cash.

2 · Two inventory systems: perpetual and periodic

There are two ways to track inventory, and which one a business uses changes how you record every purchase and sale.

Perpetual system: Inventory and Cost of Goods Sold are updated continuously — every purchase increases Inventory, and every sale records COGS on the spot. Most modern businesses use it (barcodes make it easy).

Periodic system: Inventory is NOT updated during the period. Purchases go into a temporary Purchases account, and Cost of Goods Sold is computed only at period end from a physical count.

We'll learn the perpetual system first (Part 1), then the periodic system (Part 2). Same transactions, different bookkeeping.

3 · Perpetual: recording purchases

Under the perpetual system, buying merchandise for resale goes straight into the Inventory account. Buy $6,000 of goods on account: debit Inventory $6,000, credit Accounts Payable $6,000.

FOB shipping point vs FOB destination: FOB shipping point: the buyer owns the goods once shipped and pays the freight (Freight-In, added to Inventory). FOB destination: the seller owns them until delivery and pays the freight (Freight-Out, an operating expense).

Freight, returns, and a purchase discount. Buy $6,000 on account, terms 2/10, n/30, FOB shipping point. Pay $200 freight: debit Inventory $200, credit Cash $200. Return $1,000 of damaged goods: debit Accounts Payable $1,000, credit Inventory $1,000. Now $5,000 is owed; pay within 10 days and take the 2% discount: debit Accounts Payable $5,000, credit Inventory $100 (the discount), credit Cash $4,900.

Read "2/10, n/30" as: 2% off if you pay within 10 days, otherwise the full amount is due in 30. In the perpetual system, both the discount and the freight adjust Inventory, because they change what the goods actually cost you.

4 · Perpetual: recording sales

Every sale under the perpetual system needs TWO entries — one for the revenue, one for the cost.

The two-entry sale. Sell goods for $9,000 on account (they cost you $5,400). Entry 1 records the revenue: debit Accounts Receivable $9,000, credit Sales Revenue $9,000. Entry 2 records the cost: debit Cost of Goods Sold $5,400, credit Inventory $5,400.

Sales Returns and Allowances / Sales Discounts: Contra-revenue accounts (debit balances) that reduce sales. A return of sold goods also restores Inventory and reverses that portion of COGS. A sales discount is the 2% a customer takes for paying early.

A return, then payment within the discount. The customer returns $1,000 of goods (cost $600): debit Sales Returns and Allowances $1,000, credit Accounts Receivable $1,000; and debit Inventory $600, credit Cost of Goods Sold $600. They pay the remaining $8,000 within the discount period (2%): debit Cash $7,840, debit Sales Discounts $160, credit Accounts Receivable $8,000.

5 · Adjusting and closing for a merchandiser

At period end a merchandiser has one extra adjusting entry: inventory shrinkage. The perpetual records say one thing; a physical count often says less (theft, breakage, error). You write the records down to the count.

Inventory shrinkage. Perpetual records show Inventory of $60,000, but the physical count is $58,000. Adjust for the $2,000 loss: debit Cost of Goods Sold $2,000, credit Inventory $2,000.

Closing is like Chapter 4, with more temporary accounts. Close Sales Revenue into Income Summary (debit Sales Revenue, credit Income Summary). Then close all the debit-balance temporaries out — Sales Returns and Allowances, Sales Discounts, Cost of Goods Sold, Freight-Out, and the operating expenses — by debiting Income Summary and crediting each. Finally close Income Summary and Drawings to Owner's Capital.

6 · The multi-step income statement

A merchandiser's income statement is usually multi-step, meaning it shows subtotals along the way instead of one big list. Read it top to bottom.

- Net sales = Sales Revenue - Sales Returns and Allowances - Sales Discounts.
- Gross profit = Net sales - Cost of goods sold.
- Income from operations = Gross profit - Operating expenses (salaries, rent, freight-out, utilities, etc.).
- Net income = Income from operations + other revenues and gains - other expenses and losses (interest revenue, interest expense, a loss on disposal, etc.).

A multi-step example. Sales $220,000, sales returns $12,000, sales discounts $8,000 -> net sales $200,000. Minus COGS $120,000 -> gross profit $80,000. Minus operating expenses $50,000 -> income from operations $30,000. With no other items, net income is $30,000.

7 · Single-step statement and the gross profit rate

A single-step income statement skips the subtotals: it lists total revenues, then total expenses, and subtracts once to get net income. Same net income, simpler layout.

Gross profit rate: Gross profit ÷ net sales, expressed as a percent. It shows how many cents of each sales dollar are left after the cost of the goods. Gross profit $80,000 ÷ net sales $200,000 = 40%.

The gross profit rate is one of the most-watched retail numbers — a falling rate warns that costs are rising faster than prices, or that discounts are eating into margin.

8 · The periodic system: the accounts

In the periodic system (Part 2), you do not touch Inventory during the period. Instead you use a set of temporary accounts, then compute cost of goods sold at the end.

- Purchases — a temporary account for merchandise bought (debit).
- Purchase Returns and Allowances — a contra account for goods sent back (credit).
- Purchase Discounts — a contra account for early-payment discounts taken (credit).
- Freight-In — the freight cost on incoming goods (debit); it's part of the cost of buying inventory.

So under periodic, a $6,000 purchase on account is: debit Purchases $6,000, credit Accounts Payable $6,000 — Inventory is untouched until the count.

9 · The periodic cost-of-goods-sold schedule

Because nothing updated Inventory during the period, you compute cost of goods sold at the end with a short schedule.

- Net purchases = Purchases - Purchase returns and allowances - Purchase discounts + Freight-In.
- Cost of goods available for sale = Beginning inventory + Net purchases.
- Cost of goods sold = Cost of goods available for sale - Ending inventory (from the physical count).

A COGS schedule. Beginning inventory $25,000. Purchases $140,000 - returns $6,000 - discounts $4,000 + freight-in $5,000 = net purchases $135,000. Goods available for sale = $25,000 + $135,000 = $160,000. Ending inventory $30,000, so cost of goods sold = $160,000 - $30,000 = $130,000.

10 · Periodic vs. perpetual: the same transaction

The same events are journalized differently in the two systems. Under periodic, purchases and their adjustments hit the special temporary accounts, and a sale records only the revenue — never COGS during the period.

- Buy goods on account: periodic -> debit Purchases, credit Accounts Payable. (Perpetual -> debit Inventory.)
- Pay freight on incoming goods: periodic -> debit Freight-In. (Perpetual -> debit Inventory.)
- Return goods to a supplier: periodic -> debit Accounts Payable, credit Purchase Returns and Allowances. (Perpetual -> credit Inventory.)

- Take a purchase discount: periodic -> credit Purchase Discounts. (Perpetual -> credit Inventory.)
- Sell goods: periodic -> debit Cash/Accounts Receivable, credit Sales Revenue only — no COGS entry until period end. (Perpetual -> also debit COGS, credit Inventory.)

Whichever system a business uses, the final gross profit and net income come out the same. Periodic just defers the cost side to a period-end calculation instead of recording it sale by sale.