

CHAPTER 5

Merchandising Operations and the Multiple-Step Income Statement

ANSWERS TO QUESTIONS

- Disagree. The steps in the accounting cycle are the same for both a merchandising company and a service company.
 - The measurement of income is conceptually the same. In both types of companies, net income (or loss) results from the matching of expenses with revenues.

- The components of revenues and expenses differ as follows:

	Merchandising	Service
Revenues	Sales revenue	Fees, Rents, etc.
Expenses	Cost of Goods Sold and Operating	Operating (only)

- Under a periodic inventory system the company does not keep track of how many units are on hand. Instead it takes a physical count at the end of the period to determine ending inventory and cost of goods sold. Under a perpetual system the company adjusts its inventory account each time it purchases or sells inventory. Thus it always has a record of its available inventory. Having knowledge of inventory balances helps a company avoid lost sales due to “stock-outs” as well as carrying too much inventory on hand (which results in additional storage and handling costs). The purchasing department can make better decisions with the aid of perpetual inventory records.

- The income measurement process is as follows:



- Income measurement in a merchandising company differs from a service company as follows: (a) sales are the primary source of revenue and (b) expenses are divided into two main categories: cost of goods sold and operating expenses.

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|--------------------------|------------------|
| Sales revenue | \$100,000 |
| Cost of goods sold | <u>70,000</u> |
| Gross profit..... | <u>\$ 30,000</u> |

- Agree. In accordance with the revenue recognition principle, sales revenues are generally considered to be recognized when the goods are transferred from the seller to the buyer; that is, when the exchange transaction occurs. The recognition of revenue is not dependent on the collection of credit sales.

- The primary source documents are (1) cash sales—cash register tapes and (2) credit sales—sales invoice.

- The entries are:

		<u>Debit</u>	<u>Credit</u>
Cash sales—	Cash.....	XX	
	Sales Revenue.....		XX
	Cost of Goods Sold.....	XX	
	Inventory.....		XX

Questions Chapter 5 (Continued)

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|--|---------------|---------------------------|----|----|
| | Credit sales— | Accounts Receivable | XX | |
| | | Sales Revenue..... | | XX |
| | | Cost of Goods Sold..... | XX | |
| | | Inventory | | XX |
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- 8.** July 19 Cash (\$800 – \$8) 792
 Sales Discounts (\$800 X 1%) 8
 Accounts Receivable (\$900 – \$100) 800
- 9.** Shipping unwanted goods to customers is generally considered unethical behavior. In addition, if proper accounting is applied, in most cases it won't achieve the desired result of increasing sales. If it is expected that the unwanted goods will be shipped back to the seller, then they should not be treated as sales in the first place. (Note: The practice of shipping more goods than were ordered in order to meet sales goals and get rid of extra inventory is referred to as channel stuffing.)
- 10.** In most industries returns are not significant, and they are therefore accounted for as they occur. When returns are expected to be significant, the company should make an adjusting entry at the end of the period to estimate the amount of returns that will result from the period's sales, so that revenues will not be overstated during the period.
- 11.** July 24 Accounts Payable (\$1,900 – \$300) 1,600
 Cash (\$1,600 – \$32) 1,568
 Inventory (\$1,600 X 2%) 32
- 12.** Gross profit..... \$560,000
 Less: Net income 230,000
 Operating expenses..... \$330,000
- 13.** Its current terms of 1/10, n/30 means that customers get a 1% discount if they pay within 10 days, otherwise they have to pay the full amount within 30 days. If they switch to 2/10, n/45 customers would get a 2% discount for paying within 10 days, otherwise they have to pay the full amount in 45 days. By offering 2%, more of Lou's customers would likely pay within the 10 day period. Management would have to determine whether it is worth the additional cost to be paid quicker. Also, by extending the full payment period from 30 to 45 days, Lou would end up receiving its money even later from its slow payers.
- 14.** The gain on the sale of the plant represents a one-time gain. That is, it won't be recurring next year. If you eliminate the effect of this one-time gain, then the company's income actually declined by \$5 million relative to the prior year. When predicting future earnings investors frequently place little weight on non-recurring events such as this.
- 15.** There are three distinguishing features in the income statement of a merchandising company: (1) a sales revenues section, (2) a cost of goods sold section, and (3) gross profit.
- 16.** The normal operating cycle for a merchandising company is likely to be longer than for a service company because inventory must first be purchased and sold, and then the receivables must be collected.