**Merchandising (Part 1) Script**

Slide 1: When we covered the Accounting Cycle, we used a service business as a model. In this two part presentation, we’ll look at those types of transactions that are unique to a merchandising business. Keep in mind, however, that other transactions such as paying rent, borrowing money and paying dividends are the same as a service business.

In this first part, we’ll look at what is a merchandising business and purchases of merchandise. In part 2, we will look at sales of merchandise and shipping terms.

Slide 2: Revenue Recognition Principle states that, in a service business, revenue is recognized when earned, whether or not cash has been received. For a merchandiser, revenue is recognized when an exchange of assets takes place. The customer gets the asset merchandise and the business gets either the asset cash or the asset A/R.

The merchandiser purchases merchandise and resells it to customers. When merchandise is purchased, it is held in an asset account called Merchandise Inventory or simply Inventory.

There are two types of merchandisers: Wholesalers and Retailers. Generally, Wholesalers purchase merchandise from Manufacturers and sell it to Retailers. Generally, Retailers purchase merchandise from Wholesalers and sell it to the end user, like when we purchase food at the grocer. There are some exceptions, such as large wholesalers selling to smaller wholesalers…

Slide 3: There are two types of Inventory systems used by merchandisers. The periodic system counts and values inventory periodically. This usually happens monthly, at a minimum, yearly. We don’t see this system used as much these days due to technology.

The perpetual system continuously counts and values inventory – think of the scanners used at the grocery store. Every time the checker runs an item over that scanner, inventory is updated. This is the system on which we will be focusing.

Slide 4: Before we get to looking at purchases, let’s compare the income statements from the two types of businesses. . The Merchandiser’s income statement shows several accounts that don’t appear on that of the Service Business. Namely, these are Sales Discounts, Sales Returns & Allowances, Cost of Goods Sold and Gross Margin. The discounts and returns and allowances are deducted from Sales Revenue – sometimes called Gross Sales or just Sales – in order to arrive at Net Sales. From this, we deduct Cost of Goods Sold – what the merchandiser paid for the merchandise. This, by the way, is an excellent example of the Matching Principle…

…Net Sales less Cost of Goods Sold gives us what is known as Gross Margin or Gross Profit. From Gross Margin, we subtract Operating Expenses and so on, just like the Service Business.

Slide 5: One other thing we see with merchandisers is known as Credit Terms. These serve as an incentive for customers to pay promptly; when a customer takes advantage and pays early, that seller recognizes this as a Sales Discount.

2/10, n/30 is read “two ten, net 30” and means if you pay in full within 10 days, you will receive a 2% discount; otherwise the full amount is due in 30 days. While this is the most common of terms, many other options can be negotiated.

Sales discounts are known as a ‘contra revenue’ account – they exist to be set next to revenue to help us arrive at a net revenue amount (similar to the contra asset account accumulated depreciation).

If you want to work along, there are some blank journal pages in the Merchandising Blank Journals.

Slide 6: Let’s look at an example: Suppose ABC Company purchases 10,000 worth of merchandise from XYZ Company on May 1st. The terms are 2/10, n/30. We record the purchase with a debit to inventory for 10,000 and a credit to A/P, as we are liable to pay for that purchase.

If ABC pays the invoice on the 9th, we’d record the payment with a debit to A/P to reduce the liability, a credit to cash for 9,800 and a credit to inventory for 200. The 200 is 2% of 10,000; we credit inventory because ABC didn’t pay 10,000. They paid 10,000 less the 200 discount, as we can see in ABC’s inventory ledger.

Slide 7: Sales Returns and Allowances is another contra revenue account we use to record both returns and allowances. A return happens when defective or otherwise unsatisfactory merchandise is returned to the vendor. An allowance happens when a price break is given with no merchandise being returned – maybe the packaging was torn, but the merchandise was still acceptable.

Slide 8: Here, we will look at a purchase return. Suppose on May 20th, ABC purchases 20,000 of merchandise from XYZ. We record the purchase in similar fashion with a debit to inventory and a credit to A/P.

On the 22nd, ABC determined that 5,000 of the merchandise was defective and returned it to XYZ. We would record this with a debit to A/P for 5,000 to reduce the liability and a credit to Inventory to reflect that 5,000 of that asset has been returned.

On the 31st, ABC paid the bill within the discount period. The journal entry would be a debit to A/P for the remaining 15,000, a credit to cash for 14,700 and a credit to inventory for 300 (which is 2% of 15,000).

Slide 9: Here, I want to show how to record an allowance. Let’s assume that ABC purchases 12,000 more merchandise from XYZ on the 7th of June with the same terms. You may notice that we indicate the date of the invoice – this is used to determine the discount period.

We record the purchase with a 12,000 debit to inventory and a 12,000 credit to A/P.

Two days later, ABC told XYZ that the merchandise was substandard and requested a price reduction, which they were granted. ABC would record that with a reduction in the liability (debit A/P) and a reduction in the value of inventory (credit inventory). There are still the same number of units of inventory, but the value has decreased.

On the 16th, ABC pays the bill within the discount period. We eliminate the payable with a debit, credit cash for 8,820 and credit inventory for 180 to further adjust the value of inventory (this keeps in good standing with the cost principle).

Slide 10: In this first part, we looked at merchandisers and their income statements, as well as merchandise purchases; in part 2, we’ll look at sales of merchandise. Also, since merchandise needs to be transported from seller to purchaser, we’ll look at shipping terms.