
Study Objective 5

Identify the unique features of the income statement for a merchandising company.

Income Statement for a Merchandising Company

The income statement for retailers and wholesalers contains three features not found in the income statement of a service enterprise. These features are: (1) a sales revenue section, (2) a cost of goods sold section, and (3) gross profit. Using assumed data for specific operating expenses, the income statement for Highpoint Electronic, Inc. is shown in Illustration 5-11.

Study Objective 6

Explain the steps in the accounting cycle for a merchandising company.

Accounting Cycle for a Merchandising Company

Up to this point, we have been primarily concerned with measuring net income in a merchandising company. We have also illustrated the basic entries in recording transactions relating to sales and purchases. Now it is time to consider the remaining steps in the accounting cycle that were identified in Chapter 4.

Each of the required steps in the cycle applies to a merchandising company. Again, a work sheet is an optional step. To illustrate the steps in the cycle, we will assume that Highpoint Electronic uses a work sheet.

ILLUSTRATION 5-11

Income statement for a merchandising company

HIGHPOINT ELECTRONIC, INC.			
Income Statement			
For the Year Ended December 31, 2013			
Sales revenues			
Sales			\$480,000
Less: Sales returns and allowances		\$ 12,000	
Sales discounts		<u>8,000</u>	<u>20,000</u>
Net sales			460,000
Cost of goods sold			
Inventory, January 1			36,000
Purchases		\$325,000	
Less: Purchases returns and allowances	\$10,400		
Purchase discounts	<u>6,800</u>	<u>17,200</u>	
Net purchases		307,800	
Add: Freight-in		<u>12,200</u>	
Cost of goods purchased			<u>320,000</u>
Cost of goods available for sale			356,000
Inventory, December 31			<u>40,000</u>
Cost of goods sold			<u>316,000</u>
Gross profit			144,000
Operating expenses			
Store salaries expense		45,000	
Rent expense		19,000	
Utilities expense		17,000	
Advertising expense		16,000	
Depreciation expense—store equipment		8,000	
Freight-out		7,000	
Insurance expense		<u>2,000</u>	
Total operating expenses			<u>114,000</u>
Net income			<u>\$ 30,000</u>

Helpful hints The far right column identifies the major subdivisions of the income statement. Moving from right to left, the next column identifies the primary items comprising cost of goods sold of \$316,000 and operating expenses of \$114,000; in addition, contra revenue items of \$20,000 are reported. The third column explains cost of goods purchased of \$320,000. The fourth column reports contra purchase items of \$17,200.

Using a Work Sheet

As indicated in Chapter 4, a work sheet enables financial statements to be prepared before the adjusting entries are journalized and posted. The steps in preparing a work sheet for a merchandising company are the same as they are for a service enterprise (see pages 131–134). The work sheet for Highpoint Electronic, shown in Illustration 5-12, contains all the income statement data explained above plus other data. The unique accounts for a merchandising company are shown in capital letters in red.

Trial Balance Columns

Data for the trial balance are obtained from the ledger balances of Highpoint Electronic at December 31. The amount shown for Merchandise Inventory, \$36,000, is the beginning inventory.

Adjustments Columns

A merchandising company generally has the same types of adjustments as a service company. As you see in the work sheet, adjustments (a), (b), and (c) are for insurance, depreciation, and salaries. These adjustments were also required for Pioneer Advertising Agency, Inc. as illustrated in Chapters 3 and 4.

ILLUSTRATION 5-12

Work sheet for merchandising company

After all adjustment data are entered on the work sheet, the equality of the adjustment column totals is established. The balances in all accounts are then extended to the adjusted trial balance columns.²

HIGHPOINT ELECTRONIC, INC.										
Work Sheet										
For the Year Ended December 31, 1968										
	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	9,500				9,500				9,500	
Accounts Receivable	16,100				16,100				16,100	
MERCHANDISE INVENTORY	36,000				36,000		36,000	40,000	40,000	
Prepaid Insurance	3,800			(a) 2,000	1,800				1,800	
Store Equipment	80,000				80,000				80,000	
Accumulated Depreciation		16,000		(b) 8,000		24,000				24,000
Accounts Payable		20,400				20,400				20,400
Common Stock		50,000				50,000				50,000
Retained Earnings		33,000				33,000				33,000
Dividends	15,000				15,000				15,000	
SALES		480,000				480,000		480,000		
SALES RETURNS AND ALLOWANCES	12,000				12,000		12,000			
SALES DISCOUNTS	8,000				8,000		8,000			
PURCHASES	325,000				325,000		325,000			
PURCHASE RETURNS AND ALLOWANCES		10,400				10,400		10,400		
PURCHASE DISCOUNTS		6,800				6,800		6,800		
FREIGHT-IN	12,200				12,200		12,200			
Freight-out	7,000				7,000		7,000			
Advertising Expense	16,000				16,000		16,000			
Rent Expense	19,000				19,000		19,000			
Store Salaries Expense	40,000		(c) 5,000		45,000		45,000			
Utilities Expense	17,000				17,000		17,000			
Totals	616,600	616,600								
Insurance Expense			(a) 2,000		2,000		2,000			
Depreciation Expense			(b) 8,000		8,000		8,000			
Salaries Payable				(c) 5,000		5,000				5,000
Totals			15,000	15,000	629,600	629,600	507,200	537,200	162,400	132,400
Net Income							30,000			30,000
Totals							537,200	537,200	162,400	162,400

Adjusted Trial Balance

The adjusted trial balance shows the balance of all accounts after adjustment at the end of the accounting period. Note that beginning inventory was not adjusted. Therefore it is extended to the adjusted trial balance in the amount of \$36,000.

²Conceptually, it can be argued that the change between the beginning and ending inventory balances should be shown on the work sheet as an adjustment. We have elected to consider the change in inventory to be part of the closing process. Both approaches are acceptable and accomplish the same objective. The adjusting entry approach is explained and illustrated in Appendix C at the end of the chapter.

Income Statement Columns

The accounts and balances that affect the income statement are transferred from the adjusted trial balance columns to the income statement columns. For Highpoint Electronic, regarding the merchandise accounts in the income statement columns, Sales of \$480,000 is shown in the credit column whereas the contra revenue accounts, Sales Returns and Allowances of \$12,000 and Sales Discounts of \$8,000, are shown in the debit column. Thus, the difference of \$460,000 is the net sales shown on the income statement. Similarly, Purchases of \$325,000 and Freight-in of \$12,200 are extended to the debit column. The contra purchase accounts, Purchase Returns and Allowances of \$10,400 and Purchase Discounts of \$6,800, are extended to the credit columns.

The work sheet procedures for the account Merchandise Inventory merit specific comment. The procedures are:

1. The beginning balance, \$36,000, is extended from the adjusted trial balance column to the **income statement debit column**. From there it can be added in reporting cost of goods available for sale in the income statement.
2. The ending inventory, \$40,000, is added to the work sheet by an **income statement credit and a balance sheet debit**. The credit makes it possible to deduct ending inventory from the cost of goods available for sale in the income statement to determine cost of goods sold. The debit means the ending inventory can be reported as an asset on the balance sheet.

These two procedures are specifically illustrated below:

	Income Statement		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.
Merchandise Inventory	(1) 36,000	40,000	(2) 40,000	

ILLUSTRATION 5-13

Work sheet procedures for inventories

The computation for cost of goods sold, taken from the income statement columns in Illustration 5-12, is as follows:

Debit Column		Credit Column	
Beginning inventory	\$ 36,000	Ending inventory	\$40,000
Purchases	325,000	Purchase returns and allowances	10,400
Freight-in	12,200	Purchase discounts	6,800
Total debits	373,200	Total credits	<u>\$57,200</u>
Less: Total credits	<u>57,200</u>		
Cost of goods sold	<u>\$316,000</u>		

ILLUSTRATION 5-14

Computation of cost of goods sold from work sheet columns

Finally, all the credits in the income statement column should be totaled and compared to the total of all the debits in the income statement column. If the credits exceed the debits, then the company has net income. In Highpoint Electronic's case there was net income of \$30,000. Conversely if the debits exceed the credits, the company would report a net loss.

Helpful hint In a periodic system, cost of goods sold is a computation—it is not a separate account with a balance.

Balance Sheet Columns

The major difference between the balance sheets of a service company and a merchandising company is inventory. For Highpoint Electronic, the ending inventory amount of \$40,000 is shown in the balance sheet debit column. Note also

that the information to prepare the retained earnings statement is also found in these columns. That is, the retained earnings account balance is \$33,000. The dividends are \$15,000. Net income results when the total of the debit column exceeds the total of the credit column in the balance sheet columns of the work sheet. Conversely, a net loss results when the total of the credits exceeds the total of the debit balances. These three amounts comprise the contents of the retained earnings statement.

Preparing Financial Statements

As is true in a service enterprise, financial statements for a merchandising company are prepared from the financial statement columns of the work sheet. The income statement for Highpoint Electronic has already been illustrated.

The retained earnings statement is as follows:

ILLUSTRATION 5-15
Retained earnings statement

HIGHPOINT ELECTRONIC, INC.	
Retained Earnings Statement	
For the Year Ended December 31, 2008	
Retained earnings, January 1	\$ 33,000
Add: Net income	30,000
	<u>63,000</u>
Less: Dividends	15,000
Retained earnings, December 31	<u>\$ 48,000</u>

The classified balance sheet, then, is as follows:

ILLUSTRATION 5-16
Classified balance sheet

HIGHPOINT ELECTRONIC, INC.	
Balance Sheet	
December 31, 2008	
	<u>Assets</u>
<u>Current assets</u>	
Cash	\$ 9,500
Accounts receivable	16,100
Merchandise inventory	40,000
Prepaid insurance	1,800
Total current assets	<u>67,400</u>
<u>Property, plant, and equipment</u>	
Store equipment	\$80,000
Less: Accumulated depreciation—store equipment	<u>24,000</u>
Total assets	<u>\$123,400</u>
	<u>Liabilities and Stockholders' Equity</u>
<u>Current liabilities</u>	
Accounts payable	\$ 20,400
Salaries payable	5,000
Total current liabilities	<u>25,400</u>
<u>Stockholders' equity</u>	
Common stock	50,000
Retained earnings	<u>48,000</u>
Total liabilities and stockholders' equity	<u>\$123,400</u>

In the balance sheet, merchandise inventory is reported as a current asset immediately below accounts receivable. Recall that items are listed under current assets in the order of liquidity. Merchandise inventory is less liquid than accounts receivable because the goods must first be sold and then collection must be made from the customer.

The normal operating cycle for a merchandising company ordinarily is longer than it is for a service company. Graphically, the cycle can be depicted as shown in Illustration 5-17.

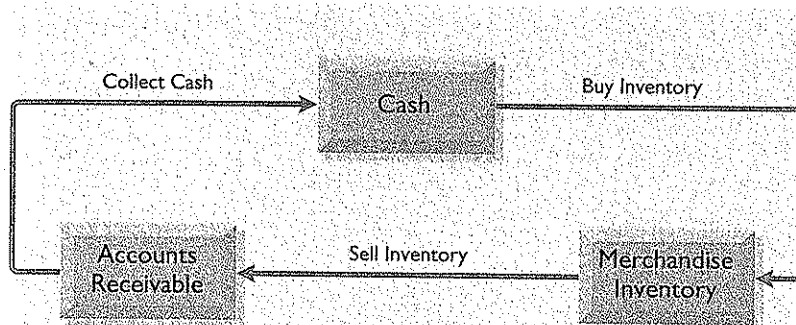


ILLUSTRATION 5-17

Operating cycle for a merchandising company

Journalizing and Posting Adjusting Entries

Adjusting entries are journalized from the adjustment columns of the work sheet. Because the journalizing and posting of the entries are the same as they are for a service enterprise, they are not illustrated here.

Journalizing and Posting Closing Entries

For a merchandising company, like a service enterprise, all accounts that affect the determination of net income are closed to Income Summary. Data for the preparation of closing entries may be obtained from the income statement columns of the work sheet. In journalizing, all debit column amounts are credited, and all credit column amounts are debited. To close the merchandise inventory:

1. The beginning inventory balance is debited to Income Summary and credited to Merchandise Inventory.
2. The ending inventory balance is debited to Merchandise Inventory and credited to Income Summary.

The two entries for Highpoint Electronic are:

Dec. 31	Income Summary	(1)	36,000	
	Merchandise Inventory			36,000
	(To close beginning inventory)			
31	Merchandise Inventory	(2)	40,000	
	Income Summary			40,000
	(To record ending inventory)			

After posting, the Merchandise Inventory and Income Summary accounts will show the following:

ILLUSTRATION 5-18

Posting closing entries for merchandise inventory

Merchandise Inventory				Income Summary				
1/1	Bal.	36,000	12/31	Close	36,000	12/31	Close	36,000
12/31						12/31	Close	40,000
12/31	Bal.	40,000						

Often, the closing of merchandise inventory is included with other closing entries, as shown below for Highpoint Electronic.

Helpful hint Except for merchandise inventory, the easiest way to prepare the first two closing entries is to identify the temporary accounts by their balances and then prepare one entry for the credits and one for the debits.

Helpful hint Close inventory with other accounts in homework problems unless stated otherwise.

Dec. 31	Merchandise Inventory (Dec. 31)	40,000	
	Sales	480,000	
	Purchase Returns and Allowances	10,400	
	Purchase Discounts	6,800	
	Income Summary		537,200
	(To record ending inventory and close accounts with credit balances)		
31	Income Summary	507,200	
	Merchandise Inventory (Jan. 1)		36,000
	Sales Returns and Allowances		12,000
	Sales Discounts		8,000
	Purchases		325,000
	Freight-in		12,200
	Store Salaries Expense		45,000
	Rent Expense		19,000
	Freight-out		7,000
	Advertising Expense		16,000
	Utilities Expense		17,000
	Depreciation Expense		8,000
	Insurance Expense		2,000
	(To close beginning inventory and other income statement accounts with debit balances)		
31	Income Summary	30,000	
	Retained Earnings		30,000
	(To close net income to retained earnings)		
31	Retained Earnings	15,000	
	Dividends		15,000
	(To close dividends to retained earnings)		

After the closing entries are posted, all temporary accounts have zero balances. In addition, Retained Earnings has a credit balance of \$48,000: beginning balance + net income - dividends (\$33,000 + \$30,000 - \$15,000).

Preparing the Post-Closing Trial Balance

After the closing entries are posted, the post-closing trial balance is prepared. The only new account in the post-closing trial balance is merchandise inventory. The post-closing trial balance for Highpoint Electronic at December 31, 1995, is shown in Illustration 5-19.

HIGHPOINT ELECTRONIC, INC.
Post-Closing Trial Balance
December 31, 1982

ILLUSTRATION 5-19

Post-closing trial balance

	<u>Debit</u>	<u>Credit</u>
Cash	\$ 9,500	
Accounts receivable	16,100	
Merchandise inventory	40,000	
Prepaid insurance	1,800	
Store equipment	80,000	
Accumulated depreciation		\$ 24,000
Accounts payable		20,400
Salaries payable		5,000
Common stock		50,000
Retained earnings		48,000
	<u>\$147,400</u>	<u>\$147,400</u>