Inventory - Merchandising

Inventory – Merchandising Operations
A company that sells products, or inventory, is called a merchandiser. Inventory consists of the products that a company sells. Inventory is an asset and is recorded on the balance sheet. It includes all costs that are necessary to buy the goods, ship them to the store, and make them ready for sale.

A merchandiser calculates net income differently than a service company. A service company calculates net income as simply revenue minus expenses.

However because of how we record inventory a merchandiser company records net income as net sales minus cost of goods sold equals gross profit. Gross profit minus expenses equals net income.

Cost of goods sold is the term used for the expense of buying and preparing inventory for sell. Cost of goods sold is recorded when the inventory is sold.

Cost of goods sold can be calculated using the following formula: Beginning inventory plus purchases equals goods available for sale minus ending inventory equals cost of goods sold.

Inventory is an asset and is reported on the balance sheet. There are two alternative ways to record inventory – perpetual and periodic.
The perpetual method, and the most common method, continually updates the accounting records for transactions involving inventory. On the other hand, the periodic method updates the accounting records only at the end of the time period. Make sure to check with your professor as to which method you will learn.

For every inventory transaction, you will need to either record a journal entry for the purchase of the inventory or for the sale of the inventory. It's important to make sure you know if the company is the company that is purchasing inventory or the company that is selling inventory. The transactions are done differently. We will look at accounting for purchases first. All of these journal entries will be prepared using a perpetual accounting system. If your professor requires that you learn the periodic accounting system, this system is not addressed in these videos.

Let's look at the transactions for Maria's Jewelry Store. Maria purchases $1,250 merchandise on June 1 paying cash. The journal entry will be recorded as a debit to merchandise inventory to record the increase of the asset and a credit to cash to record the decrease of the cash account.

Inventory can also be purchased on credit. The term on credit simply means that the company owes the supplier. Let's assume that Maria's Jewelry Store purchases merchandise inventory for $2,000 on credit. Maria will record a debit to merchandise inventory for $2,000 and a credit to Accounts Payable.

Usually when a company purchases inventory the seller will state the credit terms. Sometimes the seller of the inventory must offer a discount if the amount owed is paid before the due date. To express this agreement, the seller would use the term 2/10, n/30. The 2 represents the percent of discount received if the buyer pays the bill early. The 10 is the number of days that the discount period is open. And if the buyer doesn't pay within the discount period, the n/30 means that the full amount is due in 30 days.

To record the journal entry for payment of the amount due within the discount period, we must first calculate the discount. The discount is calculated by multiplying the amount due times the discount or 2,000 * .02 which equals $40. The discount is recorded by decreasing the merchandise inventory account. So the journal entry to record this transaction would be a debit to accounts payable to reduce the full amount of the amount owed. A credit to merchandise inventory to reduce the inventory by the amount of the discount and a credit to cash for the amount paid – the full amount (or gross) minus the discount.

Instead, let's assume that the bill was not paid during the discount period. This journal entry would not record a discount. Instead, the company would simply debit accounts payable to decrease the amount owed and credit cash.

Sometimes a merchandiser must return inventory that was purchased. To record a return of inventory, we usually will record a debit to accounts payable to show that the amount is no longer owed (this could also be cash if the merchandiser received a cash refund) and a credit to inventory.

Now that we understand how to record basic purchase journal entries, let's look at how to record sales of inventory.

Using this example, Maria's Jewelry Store sells merchandise on credit on July 15 for $3,300. The cost of the merchandise sold is $2,000. Remember that the term on credit means that the customer did not pay cash and owes me the amount due.
First the accountant must record the sale of the inventory. This journal entry is highlighted in red above. We will record a debit to accounts receivable to show that the amount of the sale is owed to the company. We will also record a credit to Sales or Sales Revenue. Remember that this is an income statement account.
We're not done with the journal entry yet, though. We also need to record the cost of the merchandise sold or the cost of goods sold and the decrease of the inventory account. Another journal entry is required when inventory is sold. This is the journal entry highlighted in yellow. A debit will be needed for cost of goods sold to record the expense of the sale of $2,000 and a credit to merchandise inventory will reduce the amount of the inventory account.

Let's look at this transaction in a little more detail so that we can fully understand the impact of this journal entry. The first part of the journal entry records the sale or revenue from the transaction. The second part of the journal entry records the cost of each sale and updates the inventory account. Notice

that we can calculate gross profit from this sale as revenues of $3,300 minus cost of goods sold of $2,000 or gross profit of $1,300. From this sale, Maria's Jewelry Store made gross profit of $1,300.

As a seller, a company can also offer discounts to the customer for payment of the amount due early. The terms used are the same as we have reviewed before. So let's assume that in the previous transaction, Maria's Jewelry Store offers terms of 1/15, n/30. Remember that this means the customer will receive a 1% discount if the bill is paid within 15 days, otherwise the full amount (no discount applied) is due within 30 days. To prepare the journal entry assuming that the customer paid within the discount we first need to calculate the amount of the discount. The discount is calculated as $3,300 times 1% or $33 discount. The discount is recorded in an account called Sales Discounts. Sales Discounts are reported on the income statement as a decrease to sales. To record this journal entry, we will record a debit to cash for the amount of cash received. $3,300 minus the discount of $33 or $3,267. Also a debit to sales discount will be recorded for the amount of the discount. The credit entry will be for the accounts receivable of $3,300 to show that the customer paid the amount owed.

Let's assume instead that the customer does not pay within the discount period. In this case, no discount will be applied. The journal entry would be recorded as simply a debit to cash for the full amount of $3,300 and a credit to accounts receivable for $3,300.

Occasionally customers will return merchandise that they purchased. To learn how to record a journal entry for return of merchandise let's look at this example. Maria's Jewelry Store received merchandise returned from customer that sold for $500 and had a cost of $300. Remember that all sales transactions involve two journal entries, one for the revenue portion and another for the cost of goods sold portion. The journal entry to record the return and decrease of revenue is recorded as a debit to sales returns and allowances and a credit to accounts receivable. The credit could also be cash if we issued a cash refund to the customer. Notice that the sales returns and allowances account is an income statement account and is recorded on the income statement as a decrease to sales. This journal entry isn't done yet, we still need to record the cost of goods sold portion. We will record a debit to merchandise inventory to show that our inventory account is increasing by amount of inventory returned and a credit to cost of goods sold.

We've learned a lot of information in this video about merchandising operations. First we learned what inventory is and then we learned how to record basic journal entries for purchasing of inventory and also for selling of inventory. The next inventory video will discuss further how to calculate cost of goods sold, or cost flow assumptions.