Think about analyzing these transactions as you review which accounts are associated with merchandising operations.

1. Recording of purchases under Perpetual Inventory system.
   a. Debit: Merchandise Inventory (Asset)  
      Credit: Cash or Accounts Payable

2. Purchase Returns – are for goods which are damaged, defective, or of inferior quality and which may be returned.
   a. Debit: Accounts Payable or cash  
      Credit: Merchandise Inventory

3. Purchase Allowance – the purchaser may choose to keep the goods which are damaged, defective, or of inferior quality provided the seller will grant a discount or allowance.
   a. Debit: A/P or cash  
      Credit: Merchandise Inventory

4. Freight Costs – Freight-in costs are the cost of transporting the goods for purchase.
   a. Freight-in is recorded:  
      Debit: Merchandise Inventory  
      Credit: Cash or Accounts Payable

5. Freight-Out – Freight costs incurred by the seller on outgoing merchandise are an operating expense to the seller.
   a. Freight-out is recorded:
      Debit: Freight-out  
      Credit: Cash or A/P

6. Purchase Discount – Credit terms are normally written 2/10, n/30 which means a 2 percent purchase discount may be taken if the invoice is paid within 10 days of the invoice date. Net amount of the invoice is due within 30 days. Purchase discounts reduce the cost of goods purchased.
7. Similarly, sales discounts reduce the revenue of goods sold. Sales Returns and Allowances is a contra revenue account to Sales. It may be used to record the return of goods.

   a. Two entries are required to record the return.
   i. 1st – debit to Sales Returns and Allowances and a credit to Accounts Receivable.
   ii. 2nd – debit to Merchandise Inventory and a credit to Cost of Goods Sold.

8. Sales Discount – The seller may offer the customer a sales discount for the prompt payment. A sales discount is usually based on the invoice price less any returns and allowances. Sales Discounts is a contra revenue account to sales. (debit balance)

   a. Debit: Sales Discount
      Debit: Cash
      Credit: Accounts Receivable

9. Both the purchase and sales of merchandising inventory can be done for cash or credit. Depending on which method of purchase/sale is used merchandising transactions can get somewhat complicated.

   a. A simple cash sale of merchandise would be recorded as a debit to cash and a credit to sales revenue. A simple credit sale of merchandise would likewise be recorded as a debit to a receivable and a credit to sales revenue.
   b. However, this is only half of the transaction when dealing with merchandise. We are required to record the cost of the goods we sold and to reduce our inventory by the amount that we sold. To do this we record the cost of goods by debiting the Cost of Goods Sold Expense and reduce inventory by crediting the Merchandise Inventory account by the cost of merchandise sold.
   c. Cash Sales
      Debit: Cash
      Credit: Sales (Revenue acct)
      Debit: Cost of Goods Sold
      Credit: Merchandise Inventory
   d. Credit Sales
      Debit: Accounts Receivable
      Credit: Sales (Revenue)
      Debit: Cost of Goods Sold
      Credit: Merchandise Inventory
10. Inventory Costing (think about analyzing the following)

a. **Purchases** of inventory **increases an asset**  
   i. Are often paid for on account (a liability), by cash, or by a combination of the two

b. Inventory accounting methods include  
   i. **FIFO** – First in First out. This method builds layers and says that the oldest (first) inventory you purchased is the first sold (out).
   ii. **LIFO** – Last in First out. This method builds layers and says that the latest (newest) inventory is the first to be sold (out).

c. Who cares?  
   i. Because the cost to you of your inventory most likely changes over time the choice of **FIFO/LIFO** can affect your profit calculation.

d. How?  
   i. Assume you have two widgets in inventory. The first was purchased last year for $1,000 and the second this year for $1,500. If you sell the widget for $2,000 this year then you receive $2,000 and the cost of what you sell would be $_______ under LIFO of $_______ under FIFO. Thus your profit under LIFO is $_______ vs. $_______ under FIFO.

11. Merchandising Operations must determine **Cost of Goods Sold**, for example, under the periodic method:

   Beginning Inventory  
   + Purchases  
   - Purchase returns  
   - Purchase discounts  
   + Freight in  
   = Cost of Goods available for sale  
   - Ending Inventory  
   = **Cost of Goods Sold**
1. **Accounts Receivable** – are amounts owed by customers often resulting from the sale of goods or the provision of services.

2. **Notes Receivable** – result from sale of goods and services and are a form of formal promissory (credit) note requiring the payment of interest.

Notes or accounts receivables that result from sales transactions are often called trade receivables.

3. **Recognition of A/R** – Merchandisers record accounts receivable at the point of sale of merchandise on account:

   Debit          A/R  
   Credit         Sales

4. **Valuing A/R** – To avoid overstating receivables on the balance sheet, they are stated at their cash (net) realizable value. (NRV)

Bad Debt expense – arises from A/R that are estimated as uncollectible. Bad Debt Expense is reported as a **selling expense** in the income statement. There are two methods used in accounting for uncollectible accounts, 1) Direct Write-off Method (not GAAP), & 2) The Allowance Method (required by GAAP) which we’ll focus on.

5. **The allowance method** is carried out by estimating uncollectible A/R, using either percentage of sales or percentage of A/R, and matching this against sales (revenue) in the same accounting period in which the sales occurred:

6. **Percent of receivables** is done by – Estimating the desired ending balance in the allowance for doubtful accounts then adjusting Bad Debt expense and the Allowance for Doubtful Accounts to achieve the desired ending allowance balance. (The Allowance for Doubtful Accounts is a **contra-asset account**.)

7. Estimated uncollectibles (estimated by either % of sales or % of receivables) are recorded as

   Debit         BAD DEBT EXPENSE  
   Credit        ALLOWANCE FOR DOUBTFUL ACCOUNT
8. Writing off of a bad account is done by a

Debit     Allowance for Doubtful Accounts
Credit     A/R

9. Collection of an account previously written off

Debit     A/R
Credit     Allowance for Doubtful Accounts

Debit     Cash
Credit     A/R

Prepayments (expenses & unearned revenue) – These often expire over time and with the expiration an expense is incurred. Adjusting entries for prepaid accounts will decrease a balance sheet account and increase an income statement account.

10. Prepaid expenses – adjustments show they have expired with the passage of time or they have been consumed (e.g. supplies).

Original Entry: (made previously)

Debit     Asset Account
Credit     Cash

Adjusting entry for prepaid expenses

Debit     expense account (show usage)
Credit     asset account (prepaid account)

11. Unearned revenues – adjustments show unearned revenues are now earned.

Original Entry: (made previously)

Debit     Cash
Credit     Liability (unearned revenue)

Adjusting entry to show revenue is now earned

Debit     Liability (unearned revenue)
Credit     Revenue
1. Property, Plant, and Equipment (PP&E) is also referred to as fixed assets, plant assets, or long-lived assets. This includes the various assets used by a company to carry out its operations and are not held for resale.

2. Equipment and Buildings (assets) are recorded at cost plus any other charges incurred to acquire and make them ready for use (e.g., shipping & set-up costs). These costs are thus “capitalized” and not expensed. (See Depreciation). Building costs are debited to the building account and equipment costs are debited to the respective equipment accounts.

3. Land, purchased for carrying out operations, is classified as a plant asset. If land is purchased for development or resale it is classified as inventory. The cost of land includes the purchase price and all costs necessary to make it ready for use (e.g., clearing and draining costs, and attorney and title fees).

4. Examples:
   
   Debit  Machine  
   Credit  Cash  
   (Purchase a machine for cash and set it up)

   Debit  Building  
   Credit  Materials  
   Credit  Wages…etc. for as many accounts as needed.  
   (Construct our own building)

   Debit  Land  
   Credit  Mortgage Payable  
   Credit  Cash  
   (Purchase land paying some cash down & taking a mortgage)

5. Depreciation
   a. This is the process of allocating an assets cost over the period of time that it is used.
   b. TERMS: Cost/Salvage Value / Depreciable Value / Useful Life
      i. Cost – historical cost of the asset.
      ii. Salvage value— an estimate of the asset’s value at the end of its useful life.
      iii. Depreciable Value— the cost less salvage value.
      iv. Useful life— estimate of the useful life.
c. Each period there will be a **depreciation expense**, to a **Nominal Account**, that reflects the loss in value of an asset due to its use in that period.

d. Depreciation is recorded in a **real account** that accumulates the total accounting loss in value due to use. This is the **ACCUMULATED DEPRECIATION** account and is a ‘**contra asset**’ account. Its **normal balance** is a **Cr**.

e. Common methods of depreciation:
   i. Straight-line –equal amount each year for the estimated useful life
   ii. Double-Declining Balance – \((1/\text{useful life}) \times 2\)

f. Who cares?
   i. The method of depreciation affects the expense that is recorded in a period and thus offsets revenue in calculating Net Income.

   \[
   \begin{array}{ll}
   \text{Debit} & \text{Dep. Expense} \\
   \text{Credit} & \text{Acc. Depreciation} \\
   \end{array}
   \]

6. The assets’ total value is reported ‘net of’ depreciation:
   
   Carrying Value (purchase price + other set up costs) 
   - Accumulated Depreciation  
   = Net Book Value

7. **Liabilities**
   a. The sources of funds used to acquire assets are (1) Liabilities and (2) equity.
   b. Liabilities are owed to creditors.
   c. Liabilities reduce the value of EQUITY, a residual claim, when we net them against assets.
   d. Liabilities have a natural credit balance.
   e. A contra account used to reduce a liability would have a debit balance.
   f. Liabilities for expenses incurred but not yet paid are called **accrued liabilities**, such as wages payable. **Failing to record one of these would result in overstated net income**. (Can you explain why?)

8. **Current Liabilities**
   a. Consistent with the definition of current assets, current liabilities are claims that become due within one year. Most companies pay current liabilities out of current assets.
   i. For example, amounts owed to employees and others for services they have provided but for which they have not been paid are listed as accrued liabilities.

9. **Long term Liabilities**
   a. Consistent with the definition of long term assets, long term liabilities reclaims that become due in more than a year.
   b. We often have to pay an interest expense when we have liabilities.
i. The amount of interest we owe is a period expense (cost) we pay for the benefit of the liability. For example, the interest we pay on a loan for being able to borrow the money.

10. Equity
   a. Equity consists of capital obtained from sources they are not liabilities, e.g., stocks rather than bonds.
   b. Paid-in Capital: is the amount of capital supplied by equity investors. These people own the company.
   c. Paid-in capital is reported in two parts: “Common Stock” and “Additional Paid-in Capital”.
1. The Primary Purpose of the Statement of Cash Flows is to provide information about cash receipts, cash payments, and the net change in cash resulting from operating, investing, and financing activities of a company during a period.

2. Statement of Cash Flows can help answer questions such as, How did cash increase when there was a net loss for the period? How were the proceeds of the bond issue used? Why were dividends not increased? How much money was borrowed during the year? And Is cash flow greater or less than net income?

3. Primary sources of information for the Statement of Cash Flows are comparative balance sheets, the current income statement, and additional other information.

4. For purposes of the Statement of Cash Flows cash receipts and disbursements are classified as either:
   a. Operating activities
   b. Investing activities
   c. Financing Activities

5. **Operating Activities** include the cash portion of transactions that create revenues and expenses and enter into determination of net income. Some cash flows relating to investing or financing activities are classified as operating activities. For example, receipts of investment interest and dividends and payments of interest to lenders are classified as operating activities because these items are reported in the income statement. For example, inflows would include cash from sale of goods or services and interest received on loans and equity dividends while outflows would include cash paid to suppliers, employees, lenders, and the government.

6. **Investing Activities** include the cash portion of transactions for purchasing and disposing of investments and productive long-lived assets, using cash and lending money, and collecting the loans. For example, inflows would include cash from sales of property, plant, and equipment and sale of debt or equity securities, and collection of principal on loans while outflows would include cash to purchase property, plant, and equipment, to purchase debt or equity securities of other entities, and to make loans to other entities.

7. **Financing Activities** include the cash portion of transactions for issuing debt and repaying the amounts borrowed and obtaining cash from stockholders and paying dividends. For example, inflows would include cash from sale of company's own stock.
or issuance of bonds while outflows would include cash paid as dividends or to redeem long-term debt or reacquire company stock.

8. Format of the Statement of Cash Flows lists three activities:

   - Operating
   - Investing
   - Financing
   PLUS
   Non-cash investing and financing activities

9. **Methods for converting net income from an accrual basis to a cash basis for the Statement of Cash Flow include the Direct and Indirect (or reconciliation) methods.**
   a. Both methods arrive at the same total amount for “Net cash” provided by operating activities.
   b. The methods differ in disclosing the items that make up the total amount.
   c. The choice of methods affects only the operating activities section; the investing and financing activities sections are the same.
   d. The direct method is preferred by the FASB but either method is allowed. When the direct method is used, the net cash flow from operating activities, as computed using the indirect method, must also be reported in a separate schedule.

10. Regardless of the method chosen the **first step** is to determine the net increase/decrease in cash.

11. The indirect method starts with net income and converts it to net cash by adjusting net income for items that affected reported net income but did not affect cash.

12. The direct method adjusts each item in the income statement from the accrual basis to the cash basis. Begin by analyzing the revenues and expenses reported in the income statement in the order in which they are reported and then determine the cash receipts and payments related to these revenues and expenses.

**Analysis of Financial Statements a.k.a. Ratios.** Ratios are most useful in identifying relationships of accounting measures and business performance.

**OVERALL MEASURES OF PERFORMANCE:**

1. **Return on Equity (ROE)** – the % return or profit obtained by investors
   \[
   \text{ROE} = \frac{\text{Net Income}}{\text{Equity}}
   \]

2. **Earnings Per Share (EPS)** – the % return or profit obtained by investors per share of common stock. Measures profitability from the common stockholders view point.
3. **Price-Earnings (PE) Ratio** – used to reflect whether investors think earnings per share will increase or decrease, on average 8 to 1.
   = Market price of stock/earnings per share

4. **The Payout Ratio** - Measures the percentage of earnings distributed in the form of cash dividends to common stockholders.
   = Total Cash Dividends Paid on Common Stock / Net Income

**OTHER MEASURES:**

1. **Profit margin** – a measure of profit for each sale
   = Net income / Sales revenue

2. **Current Ratio** – a measure of a company’s ability to meet its current obligations
   = Current Assets / Current Liabilities

3. **Quick (Acid) Ratio** – a measure similar to current ratio but reduced by inventory
   = (Current Assets – Inventory) / Current Liabilities

4. **Debt Ratio** – a measure of a company’s financial risk, on average <50%
   = Non-current Liabilities / (Non-current Liabilities + Equity)

5. **Debt to Assets Ratio** – measure of assets financed by creditors and thus financial risk.
   = Total liabilities / Total Assets

**EVALUATING THE RECEIVABLES BALANCE**

1. **Receivable Turnover Ratio** – how quickly receivable asset can be converted into cash.
   = Net Credit / Average Acc Receivable

2. **Average Collection Period** – Average number of days to collect the accounts receivable
   = 365 days / Receivables Turnover Ratio