**NEAR EAST UNIVERSITY**

**ACC 203 Course Notes\***

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**\*: Notes are taken from the text book of the course: Financial & Managerial Accounting, 14th Edition,** Williams, Haka, Bettner, Carcello, ISBN: 0-07-018189-2, Publisher: McGraw-Hill

# MARCHANDISING ACTIVITIES

## Operating Cycle of a Marchandising Company

The operating cycle of a business is the time it takes a business to start with cash, purchase inventory, sell the inventory, and finally collect cash from customers.

The operating cycle of a business that sells inventory on credit is typically longer than that of a business that sells only on a cash basis. This is due to additional time between when a customer buys inventory and when the customer pays off the accounts receivable.

## The Income Statements of a Merchandising Companies

The income statements of merchandising companies have an additional expense item called Cost of Goods Sold. The Cost of Goods Sold account represents the cost of merchandise sold during the period to help earn revenue.

Cost of Goods Sold is presented as a separate expense item on the income statement. Net Sales minus Cost of Goods Sold equals Gross Profit. Gross Profit is the amount left, after subtracting the cost of the inventory sold, to cover all other expenses and a profit.

## Perpetual Inventory System

In the perpetual inventory system, the inventory account is continuously updated to reflect purchases, sales, and returns of inventory.

## Taking a Physical Inventory

Most companies take a physical count of inventory at least once a year. Theoretically, the physical count should match the number of items in the inventory records. In reality, this is not the case. The physical count does not match the records due to spoilage, breakage, damage, obsolescence, and theft. The physical count helps get the records up to date to reflect what is actually on hand.

When a physical count identifies inventory shrinkage, an entry is made to debit Cost of Goods Sold and credit Inventory. This entry increases Cost of Goods Sold, an expense account, and decreases the Inventory account.

## Periodic Inventory System

Under the periodic inventory system, no effort is made to keep the inventory account or the cost of goods sold account up to date. Only on a periodic basis are these two accounts updated.

The cost entry that was made under the perpetual inventory system is not required because the periodic system does not attempt to keep the inventory and cost of good sold accounts up to date.

Because the periodic system does not maintain a cost of goods sold account, cost of goods sold must be calculated at the end of the period.

To calculate the cost of goods sold for Party Supply, start with the beginning inventory and add the purchases during the year. This provides the cost of goods available for sale during the period. From this, subtract the ending inventory and arrive at the cost of goods sold during the period.

After special closing entries, the Purchases account is closed, the Inventory account reflects the ending inventory amount, and the Cost of Goods Sold account reflects the calculated cost of goods sold amount.

The remaining steps for completing closing entries in a periodic inventory system are the same as discussed earlier for the perpetual inventory system.

## Selecting an Inventory System

Which inventory system should a company use? This table suggests some characteristics to consider when selecting an inventory system. If a company has a professional management team, needs timely information about items in inventory, and has a computerized accounting system, then a perpetual inventory system is likely the better option. However, if a company is run by its owners, does not need timely information about items in inventory, uses a manual accounting system, and maintains merchandise on site, then a periodic inventory may be the solution.

Many companies can find an accounting software package that is able to handle a perpetual inventory system very effectively.

# INVENTORIES & COGS

Inventory includes all goods that a company owns and holds for sale, regardless of where the goods are located when inventory is counted. Inventory is reported as a current asset on the balance sheet.

Companies that sell inventory report the value of the inventory they have in stock at the end of the period as a current asset on the balance sheet.

Companies that sell inventory also have an additional expense item called Cost of Goods Sold on their income statements. The Cost of Goods Sold account represents the cost of the inventory sold during the period to help earn revenue.

Cost of Goods Sold is presented as a separate expense item on the income statement. Net Sales minus Cost of Goods Sold equals Gross Profit. Gross Profit is the amount left, after subtracting the cost of inventory sold, to cover all other expenses and a profit.

## Specific Identification

When using the specific identification method, the specific cost of each unit that is sold is known. It is most commonly used in businesses that have low sales volume of high dollar items, like car dealerships, exclusive jewelry stores, and custom builders.

## Average Cost Method

To determine the average cost of the inventory items, the cost of goods available for sale divided by the total units in inventory. Then the average cost per unit is calculated.

The unit on hand is determined by taking the total units purchased and by subtracting the units sold.

## FIFO Method

When using the First-in, First-out (FIFO) method, the older costs are assigned to the units sold. That leaves the more recent costs to be used to value ending inventory.

## LIFO Method

When using the Last-in, First-out (LIFO) method, we assign the most recent costs to the units sold. That leaves the older costs to be used to value ending inventory.



# PLANT AND INTANGIBLE ASSETS

Plant assets represent a bundle of future services, and can be thought of as long-term prepaid expenses. They are tangible assets that are used actively in the operations of an entity. It’s fully expected that these assets, sometimes referred to as property, plant, and equipment, will benefit future periods.

When a plant asset is acquired, it is recorded at its historical cost. Once the asset is placed in service, a portion of the asset’s cost is allocated to depreciation expense as the asset becomes older.

There are three major categories of plant assets: Tangible plant assets are long-term assets that have physical substance. Examples include land, buildings, equipment, furniture, and fixtures. Intangible assets are noncurrent assets with no physical substance. Examples include patents, copyrights, trademarks, franchises, and goodwill. Natural resources are acquired for extracting valuable resources to be used in the business. Examples include oil reserves, timber, and other minerals.

## Acquisition of Plant Assets

The cost of a plant asset includes the purchase price as well as all costs necessary to get the asset in place and ready for its intended use. The purchase price, net of any cash discounts available, is recorded.

Finance charges are not included in the cost of an asset. If a purchase is financed over a period of time, the interest cost is charged as an expense when incurred.

When purchasing land, the cost includes the purchase price and other costs generally incurred in connection with land acquisitions. Many of these costs are related to obtaining legal title to the land. Also remember that land is not a depreciable plant asset.

Land improvements include parking lots, driveways, fences, sidewalks, landscaping, and any outdoor lighting systems. Land improvements are depreciated over their useful life.

Whether we purchase or construct a building, the cost should include the purchase price plus any attorney fees, title fees, and repairs made prior to using the building. If the building is built, the cost will include all the necessary construction costs as well as the costs just mentioned.

Machinery and equipment are recorded at their purchase price less any available cash discount. If the company pays delivery charges on a truck, these costs are included in the cost of the truck. If any special parts need to be installed to make the machinery or equipment ready for its intended use, these costs will be included in the price of these assets. Insurance and property taxes are expenses in the current period; they are not part of the acquisition cost of an asset.

It is not uncommon to have a lump-sum purchase of assets. The most common example may be when purchasing a building and land.

Remember, the land is not depreciable but a building is. A portion of the purchase price must be assigned *separately* to the building and to the land. When faced with this type of problem, accountants normally divide the cost between the assets on the basis of relative fair market values.

## Capital Expenditures and Revenue Expenditures

After a plant asset is purchased, the company may incur additional expenditures on that asset. These expenditures may be for repairs and maintenance, overhauls, upgrading the asset, and similar expenditures.

One way to handle these types of expenditures is to treat them as Capital Expenditures and charge the amounts to an asset account on the balance sheet. In some cases, the expenditures may be treated as Revenue Expenditures and charged to current period income as expenses.

For each expenditure subsequent to acquisition of a plant asset, decide if the expenditure is to be treated as a Capital or Revenue expenditure.

Generally, subsequent expenditures for ordinary repairs are treated as revenue expenditures and charged to current period income as expenses. Subsequent expenditures that are for betterments are classified as extraordinary repairs. These should be treated as capital expenditures and charged to the asset account.

## Depreciation

Depreciation is a process of cost allocation. The cost of an asset is allocated to expense over its useful life in some rational and systematic manner. Do not confuse asset valuation, an *economic* concept, with allocation.

The unused portion of the asset’s cost appears on the balance sheet. A portion of the cost is allocated to expense on the income statement each accounting period.

When dealing with depreciation, there are several terms and concepts to understand.

Book value is calculated as the historical cost of the asset minus the accumulated depreciation. Book value is the undepreciated cost of the asset.

Accumulated depreciation represents the depreciation taken on the asset since its purchase. Accumulated depreciation is a contra-asset account and is subtracted from the asset account to determine book value.

Assets are depreciated as we use them to help earn revenue. As assets are used, they incur physical deterioration and obsolescence.

## Straight Line Depreciation

Regardless of the method used to calculate depreciation expense, three variables must be known: (1) the asset’s cost; (2) the estimated residual value expected to be received at the end of its useful life, and (3) the estimated useful life of the asset.

When using the straight-line method, depreciation expense is calculated by taking cost minus residual value and dividing by the years of useful life.

## Declining Balance Method

There are several appealing reasons to use a declining-balance method for depreciation. One reason to consider the *declining-balance method* is to better match depreciation expense with revenue generated. The idea is that a newer asset will generate more revenue in early years rather than later years, so depreciation expense should be higher in the early years of ownership and less in later years. Another reason that the declining-balance method is appealing to use for financial statement reporting is that it is similar to the depreciation method used for tax purposes.

Calculating depreciation expense under the double-declining-balance method is a three step process. The first step is to calculate the straight-line depreciation rate. Do this by dividing one hundred percent by the asset’s useful life.

The second step is to calculate the double-declining-balance rate, which is done by multiplying the straight-line rate times two.

The third and final step is to determine depreciation expense. Multiply the double-declining rate times the book value of the asset at the beginning of the period. Under the double-declining-balance method estimated residual value is ignored.

# LIABILITIES

Liabilities are debts owed from past transactions. Liabilities can be separated into two categories: Current and Non-current.

Current liabilities are due to be paid within one year or the normal operating cycle of the business, whichever is longer. For most businesses, one year is longer than the operating cycle.

Noncurrent liabilities are due to be paid sometime after one year.

Accounts Payable are short-term obligations for purchases of merchandise and other goods and services that are used in the normal operations of a business.

Many Notes Payable require payments on a regular basis during the life of the note. For example, many home mortgages are for fifteen or thirty years. But homeowners do not wait until the end of the fifteen or thirty years to make a payment. They usually make monthly payments during the loan term.

Remember that any debt due within one year is classified as current. The portion of a note payable that is due within one year would be classified as a current liability. The remainder of the note that is due outside of one year is classified as noncurrent.

A note is a written promise to pay a specific amount at a specific future date.

A note includes the following necessary information about the agreement. The payee on the note is the recipient of the cash at maturity. Notes also include information about the principal, interest rate, and due date.

## Types of Bonds

There are several types of bonds. For Mortgage bonds, the issuer pledges specific assets as collateral. Debenture bonds are backed by the issuer’s general credit standing. Convertible bonds can be exchanged for a fixed number of common shares of the issuing corporation. Junk bonds have very high risk associated with them.

# STOCKHOLDERS’ EQUITY: PAID-IN CAPITAL

Corporations are entities created by law that exist separately from their owners and have rights and privileges. Ownership in a corporation can be publicly or privately held. Owners of a corporation are called stockholders. The assets of a corporation belong to the corporation itself, not to the stockholders. The corporation is responsible for its own debts and must pay income taxes on its earnings.

## Advantages of Incorporation

The corporate form of organization has several advantages. Corporations are separate legal entities that can enter into contracts, sue, and be sued. Stockholders’ losses are limited to the amount invested in the corporation. Ownership rights are transferable. Most corporations have a professional management team that runs the business on a day-to-day basis. The corporation continues to exist even when ownership changes.

## Disadvantages of Incorporation

There are also several disadvantages of incorporation. There are extra governmental regulations imposed on corporations and corporate taxation of earnings. Corporations pay taxes on their earnings and if they distribute a dividend to stockholders, the stockholders pay taxes on the dividends received. This is sometimes referred to as double taxation. It’s also costly to form a corporation. And, the separation of stockholder owners from management can create problems as well if management does not act in the best interest of the owners, but rather in the best interest of the management team.

## Rights of Stockholders

Stockholders have several rights. They have a right to vote at stockholders’ meetings; they can sell and buy shares of stock; they receive dividends declared by the Board of Directors; and in the event of liquidation, they share equally in any remaining assets after creditors are paid.

At their annual meeting, stockholders elect the Board of Directors and vote on important management issues facing the company. The primary functions of the board of directors are to set corporate policies and to protect the interests of the stockholders.

## Functions of the Board of Directors

The primary functions of the board of directors are to set corporate policies and to protect the interests of the stockholders. Specific duties of the directors include hiring corporate officers and setting those officers’ salaries, declaring dividends, and reviewing the findings of both internal auditors and independent auditors.

## Stockholders’s Equity

Stockholders’ equity can be increased in two ways. First, equity is increased by issuing stock to investors. This is an increase in Paid-in Capital. Second, equity is increased by the retention of profits earned by the corporation. This is an increase in Retained Earnings.

Issued shares can be classified as outstanding shares and treasury shares. Outstanding shares are shares that are currently owned by stockholders.

Treasury shares are shares that once were owned by stockholders but were repurchased by the corporation in the stock market. Thus, the corporation is now the owner of those shares.

## Preferred Stock

Preferred stock is a separate class of stock that typically has priority over common stock in dividend distributions and distribution of assets in a liquidation.

Preferred stock usually has a stated dividend that is expressed as a percentage of its par value. It normally does not have voting rights and is often callable by the corporation at a stated value.

# STATEMENT OF CASH FLOWS

The Statement of Cash Flows helps users determine how a company obtains its cash and where the cash is spent. Providing this information helps explain changes in the cash balance from the beginning to the end of the period.

While it is important for users to know how much cash a company has, it is also important to know how a company funded it operations. Did it have to borrow money or sell stock to help pay the operating expenses? If so, users need to be aware of this so they can fully assess the cash flow position of the company.

Cash flow information is also useful in determining whether a business has sufficient cash to pay its debts, and/or if the business paid dividends during the period.

There are three main sections on the statement: operating, investing, and financing activities. The bottom of the statement reconciles the change in cash with the beginning and ending cash balances. The ending cash balance on the Statement of Cash Flows should always equal the cash balance on the Balance Sheet.

The Operating Activities section includes cash inflows and outflows that result from the operations of the business, and some incidental business transactions. Operating cash inflows include cash received from customers in payment of goods sold as well as cash received as dividends and interest. Operating cash outflows include cash payments for salaries, supplies, inventory, taxes, and interest.

The Investing Activities section includes cash inflows and outflows that result from the sale and purchase of fixed assets and investments. If a company purchases a piece of equipment, it is classified as a cash outflow in the investing section. If a company has excess cash and invests it in the stock of another company, it is also classified as a cash outflow in the investing section. If this equity investment is sold in the future, it will be classified as a cash inflow in the investing section.

The Financing Activities section includes cash inflows and outflows that result from transactions with the company’s creditors and stockholders. If a company borrows money from a bank, it is classified as a cash inflow in the financing section. If this debt is repaid in the future, *the amount of the principal payment* is classified as a cash outflow in the financing section. Remember, the interest payment is classified as a cash outflow in the operating section. If a company issues stock of the company, it is classified as a cash inflow in the financing section.