

## Chapter 8 • Accounting for Purchases, Accounts Payable, and Cash Payments

### TEACHING OBJECTIVES

- 8-1) Record purchases of merchandise on credit in a general journal.
- 8-2) Compute the net delivered cost of purchases.
- 8-3) Post from the general journal to the general ledger accounts.
- 8-4) Post transactions to the accounts payable subsidiary ledger.
- 8-5) Prepare a schedule of accounts payable.
- 8-6) Demonstrate a knowledge of the procedures for effective internal control of purchases.
- 8-7) Record purchases, sales, returns, cash payments, and cash receipts using the perpetual inventory system.

### SECTIONS

- 1. Merchandising Purchases
  - 2. Accounts Payable
- 

### CHAPTER OVERVIEW/ LEARNING OBJECTIVES

**Learning Link: Chapter 7 discussed the accounting for various sales and sales related transactions typically engaged in by merchandising firms. Chapter 8 discusses the accounting for purchases and the purchase-related transactions.**

- 8-1. This chapter explains how an organization manages its purchases of goods for resale and its accounts payable.
- 8-2. It reviews the steps of Purchasing procedures followed and the related documents used such as purchase requisitions, purchase orders and invoices.
- 8-3. The steps to post from the *general journal* to the *general ledger* accounts are explained.
- 8-4. The chapter introduces various accounts such as *Purchases, Purchase Returns and Allowances, Purchase Discounts and Freight In*. It also summarizes the posting procedures.
- 8-5. The chapter explains that *Purchase Returns and Allowances* is a contra expense account under the category of cost of goods sold. It explains that vendor returns are credited to this account instead of the *Purchases* account. It also explains that the balance of the *Purchase Returns and Allowances* account is subtracted from the “delivered cost of purchases” on the income statement to arrive at the net delivered cost of purchases.

- 8-6. The chapter discusses Cash Discounts offered by suppliers to encourage quick payment by customers. To the person taking advantage of the prompt pay discount, the account used is known as ***Purchases Discount***.
- 8-7. The chapter discusses how to calculate the *net delivered cost of purchases* by adding the cost of purchases and freight in, and then subtracting any purchase returns and allowance and discounts.
- 8-8. The chapter explains the recording of merchandise purchased with a ***Trade Discount***.
- 8-9. The chapter explains how to post from the general journal to the vendors' accounts in the ***Accounts Payable Subsidiary Ledger***. The accounts of individual creditors are kept in this subsidiary ledger.
- 8-10. The chapter reviews the steps required to prepare a schedule of accounts payable based on the ***Accounts Payable Subsidiary Ledger***.
- 8-11. The chapter introduces the concept of effective internal control regarding purchases and payments. The system should ensure that purchases and payments are properly authorized and processed with appropriate documentation to provide a system of checks and balances.
- 8-12. This chapter discusses how to record the purchases, sales, returns, cash payments, and cash receipts using the perpetual inventory system. It compares journal entries under both the periodic system and the perpetual system of accounting.

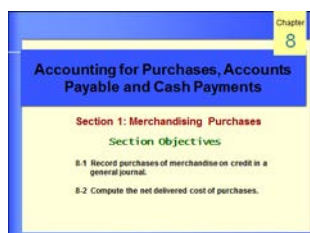
At the beginning of the chapter, there is a short paragraph about *Williams-Sonoma*. . Let's read this together. . .



Ask. . . "How do you think *Williams-Sonoma* buyers determine the types of products that will appeal to its customers?"

**Answer--** Students may discuss one or more of the following merchandise selection tools: consumer surveys, customer requests, or sales history reports.

- **FAST FACTS:** Williams Sonoma began in 1956, when Chuck Williams opened a small specialty cookware shop in Sonoma, California.
- Much of the French kitchen equipment that they sold had never been seen by Americans before.
- These strategies seem to be paying off. Since its opening, it has evolved into a multi-billion dollar corporation with net earnings that increased by 15% for the year ended 1-29-12.

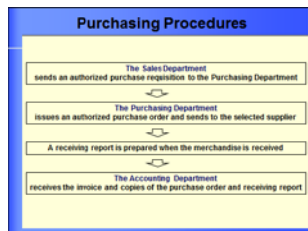
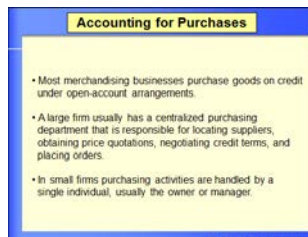


## **Section 1. MERCHANDISING PURCHASES**



Ask, "Do you think it would be feasible to allow every person who works at a business to buy and order merchandise? Think about some place like Pier 1. . . " **Guide them to the realization that only selected employees may buy merchandise with appropriate approvals.**

- Emphasize how the use of purchase requisitions, purchase orders, receiving reports, and invoices help control business expenditures.



## A. Accounting for Purchases

- Explain that most merchandising businesses purchase goods on credit under open-account arrangements.
- Point out that in a small firm, purchasing activities are handled by a single individual, usually the owner or manager. In a larger company, a centralized purchasing department may exist.

### ◆ Purchasing Procedures

- Define "*purchase requisition*", "*purchase order*", "*receiving report*", "*purchase invoice*" and "*sales invoice*".
- Explain that these documents help maintain internal control over purchases.
- Review the purchasing paperwork and flow of document-creation illustrated in Figures 8-1, 8-2 and 8-3:
  - Figure 8-1, Purchase Requisition-- Review with students each of the items in the figure.
  - Figure 8-2, Purchase Order--Point out that purchase order allows a seller to ship goods based on a purchaser's commitment. (Point out the purchase order number is needed for effective control of the purchasing process.)

**Invoice**

Modern Sportsman  
1718 Shelby Lane  
Lubbock, TX 79402

INVOICE NO. 1188

SOLD TO: Men's Out Sporting Goods  
2001 International Center  
Dallas, TX 75288-0967

DATE: January 15, 2016  
ORDER NO.: 9001  
SHIPPED BY: Priority Express

ITEM DESCRIPTION	QUANTITY	UNIT PRICE	TOTAL PRICE
Men's Out Sporting Goods	10	470.00	4,700.00
Freight			8,300.00
<b>Total</b>			<b>13,000.00</b>

This is a purchase invoice for the customer  
This is a sales invoice for the seller

**Account Classifications**

Name of Accounts	Type of Account	Normal Balance	Used to Record:
Purchases	Expense	DR	Purchases of merchandise inventory
Purchases Returns and Allowances	Contra expense	CR	Returns of merchandise inventory to seller on the buyer's books
Purchases Discounts	Contra expense	CR	Record cash discounts taken for early payments to the seller by the buyer
Freight In or Transportation In	Expense	DR	Record payment of transportation costs on merchandise inventory purchased

**The Purchases Account**

QUESTION:  
What is the *Purchases* account?

ANSWER:  
The *Purchases* account is an account used to record cost of goods bought for resale during a period.

Wow! I need to order more inventory!

- Figure 8-3, Invoice—Have students identify terms of the purchase and explain what those terms mean.
- Briefly explain students the various accounts used—Purchases, Purchases Returns and Allowances, Purchase Discounts and Freight In.
- Point out the freight charge on the invoice.



Ask, "What account would you charge for this expense?"

### ◆ The Purchases Account

- Explain that the purchase of merchandise for resale is a cost of doing business. When a business buys merchandise it debits an account called "*Purchases*."
- Explain that the *Purchases* account does not include all business purchases.
- Emphasize that *Purchases* is debited only for the cost of merchandise that is purchased for resale.
- Explain that the *Purchases* is a temporary expense account classified as Cost of Goods Sold containing costs of merchandise sold to customers.
- Emphasize that it is not an asset account. Even though merchandise being purchased is indeed an asset, when it is sold it becomes an expense.

- Point out that the account follows the debit and credit rules of expense accounts.

**Purchases And Cash Payments With Freight Charges**

QUESTION:  
What is the *Freight In* account?

ANSWER:  
The *Freight In* account is an account showing transportation charges for items purchased. It is also called Transportation In account.

◆ **Purchases and Cash Payments with Freight Charges**



Ask, "Have any of you ever purchased an item and received a bill that included charges for shipping?"



Ask, "Did the shipping charges increase your cost of the item (the total amount you had to pay)?"

- Explain that businesses also usually pay shipping charges for all inventory items they purchase.

- Point out that the account *Freight In* or *Transportation In* is used to keep track of freight charges for merchandise we purchase.

- Explain that the account is treated as a *Cost of Goods Sold* account because it increases the cost of the merchandise purchased.

- Emphasize that it is not this account that is used for freight costs that the business incurs to ship an item to a customer. For shipping charges to a customer the business uses a separate expense account—perhaps *Freight Out*.

- *Explain the* difference between (FOB) shipping point, and FOB destination.

**FOB shipping point and FOB destination**

(FOB) shipping point:  
Buyer pays the freight charge—the cost of shipping the goods from the seller's warehouse to the buyer's location

FOB destination:  
Seller pays the freight charges

Two ways to handle the freight charges paid by the buyer:

- Buyer is billed directly by the transportation company for the freight charge.
- Seller pays the freight charge and includes it on the invoice.

**Cost of Goods Sold**

Price of goods (debit Purchases)	\$4,760.00
Freight charge (debit Freight In)	360.00
Total invoice (credit Accounts Payable)	\$5,120.00

Purchases		+	Freight In		=	Accounts Payable	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
4,760			360			5,120	

The cost of goods sold accounts have normal debit balances

## Objective 8-1

Record purchases of merchandise on credit in a general journal.

## Objective 8-1

### ◆ Record purchases of merchandise on credit in a General Journal

Point out that it is important to write the detailed information about the *vendor name* and *invoice* number for reference later.



Ask "Why is it important to keep track of the *Invoice Date* and *Terms* of an invoice?"

**Purchases with Freight**

DATE	DESCRIPTION	DEBIT	CREDIT
Jan. 15	Purchases	4,750.00	
	Freight In	350.00	
	Accounts Payable		5,100.00
	Purchased merchandise from Modern Sportswear, Invoice 1100		
		4,750	5,100

**Payment of Invoice with freight**

The journal entry to record payment of this invoice on January 30 using check number 152 appears below:

DATE	DESCRIPTION	DEBIT	CREDIT
Jan. 30	Accounts Payable	5,100.00	
	Cash		5,100.00
	Paid Modern Sportswear Invoice 1100, Check 152		

**Purchases Returns and Allowances**

A **purchase return** is a return of unsatisfactory goods

A **purchase allowance** is a reduction in the price of the goods



Ask, "Why do you think an understanding of credit policies and credit terms might help a retail store manager direct the operations of the store more effectively?"

**Answer—Answers will vary.** Store managers are responsible for a wide range of operations and procedures. The extension of credit, utilizing proprietary credit cards or customer accounts, requires that managers understand common credit practices so that policies are established within generally accepted parameters. Managers should also understand how credit policies impact accounts receivable and cash flow.

## B. Purchases Returns and Allowances

- Explain that when a business returns merchandise to a vendor, it makes an

A credit to the *Purchase Returns and Allowances* account is made when a vendor returns something to a supplier.

**Purchases Returns and Allowances**

Returns and Allowances

- A complete record of returns and allowances
- A contra cost of goods sold account
- Normal credit balance

**Recording Purchases Returns And Allowances**

On January 15 Maxx-Out Sporting Goods received merchandise costing \$4,760 from Modern Sportsman with freight charges of \$300 paid by Modern Sportsman. This is the original entry that was made on January 15.

GENERAL JOURNAL					PAGE	F
DATE	DESCRIPTION	POST	DEBIT	CREDIT		
2018						
Jan. 15	Purchases		4,760.00			
	Freight In		300.00			
	Accounts Payable			5,060.00		
	Purchased merchandise from Modern Sportsman, Invoice 1100					

**Recording Purchases Returns And Allowances**

Some goods received from the January 15 purchase were damaged, and the supplier granted a \$476 purchase allowance on their credit memo #103 dated January 27.

GENERAL JOURNAL					PAGE	F
DATE	DESCRIPTION	POST	DEBIT	CREDIT		
2018						
Jan. 27	Accounts Payable		476.00			
	Purchase Returns and Allowances			476.00		
	Received Credit Memo 103 for an allowance for damaged merchandise original Invoice 1100, January 15, 2018					

**Recording the payment on account:**

Accounts Payable		Purchases Returns and Allowances	
476		476	

GENERAL JOURNAL					PAGE	F
DATE	DESCRIPTION	POST	DEBIT	CREDIT		
2018						
Jan. 27	Accounts Payable		4,584.00			
	Cash			4,584.00		
	Paid amount due on Invoice 1100 to Modern Sportsman after receipt of Credit Memo 103, Check 151					

**Purchases Discounts**

- Net 30 days or n/30: Payment in full is due 30 days after the date of the invoice.
- Net 10 days EOM, or n/10 EOM: Payment in full is due 10 days after the end of the month in which the invoice was issued.
- 2% 10 days, net 30 days; or 2/10, n/30: If payment is made within 10 days of the invoice date, the customer can take a 2 percent discount. Otherwise, payment in full is due in 30 days.

**Recording Purchases Discounts**

Maxx-Out Sporting Goods received merchandise costing \$3,000 from The Modern Sportsman on January 10, Invoice 880, terms 2/10, n/30, with freight charges of \$200 paid by Modern Sportsman and added to the invoice.

GENERAL JOURNAL					PAGE	F
DATE	DESCRIPTION	POST	DEBIT	CREDIT		
2018						
Jan. 10	Purchases		3,200.00			
	Freight In		200.00			
	Accounts Payable			3,400.00		
	Purchased merchandise from Modern Sportsman, Invoice 880, terms 2/10, n/30					

**Recording Purchases Discounts**

Maxx-Out Sporting Goods paid the amount due, after deducting a \$60 discount (\$3,000 × 2%), on January 19 with check number 150.

GENERAL JOURNAL					PAGE	F
DATE	DESCRIPTION	POST	DEBIT	CREDIT		
2018						
Jan. 19	Accounts Payable		3,340.00			
	Purchase Discounts			60.00		
	Cash			3,340.00		
	Paid balance owed to Modern Sportsman, Invoice 880, Check 150					

- opposite entry to that of a purchase, but instead of crediting the Purchases account, a credit is made to the Purchase Returns and Allowances account.

- Point out that the *Purchase Returns and Allowances* account is a **contra expense under cost of goods sold** category that keeps track of all merchandise returns the business made.



Ask, "Why would a business want to keep track of returns it makes?" It may indicate that the business need to find a new vendor(s).

- Remind students that the Purchase Returns and Allowances account would appear on the Income Statement as a reduction in the cost of purchases.

### ◆ Recording Purchases Returns and Allowances

- Review the journal entry required for a purchase return and the use of Purchase Returns and Allowance account.
- A credit to the *Purchases Returns and Allowances* account is preferred to making a credit directly to the Purchases account.

### ◆ Recording Purchases Discounts


- Purchase discounts are given to encourage early payment.
- **TEACHING TIP:** Give students this scenario: *The Trend Center* purchased merchandise for \$1,000, with terms of 2/10, n/30.




**Purchase return processed within the discount period**

If there is a purchase return processed within the discount period, the buyer is entitled to take the cash discount only on the balance owed after the return.

GENERAL JOURNAL		DATE	DEBIT	CREDIT
10/10				
10/10	20 Accounts Payable		4,720.00	
	Purchase Discounts			20.00
	Cash			4,740.00
	Paid amount owed to Hubert			
	Specialize Service \$10			
	Check 148			

 Ask, "How much of a discount are they entitled to if they pay within the discount period?" **Answer \$20.**

 Ask, "Should the business save \$20 by paying the invoice within 10 days, or conserve cash and treat the \$20 as a reasonable charge for having the use of \$980 for an additional 20 days?" ( $\$20 \div (\$980 \times 20/365) = .372$  or 37.2%.)

**Yikes! The business should pay within the 10 days!**

- Review with students the terms "cash discount," "purchases discount," and "sales discount".
- Explain the students the various ways to express the credit terms that often appear on invoices.
- Review the journal entry required for a purchase return processed within the discount period.

Objective 8-2 Compute the net delivered cost of purchases.

**Determining the cost of purchases**

The income statement of a merchandising business contains a section showing the total cost of purchases.

This section combines information about

- Cost of the purchases
- Freight in
- Purchases returns and allowances
- Purchase Discounts

## Objective 8-2

- ◆ **Compute the net delivered cost of purchases.**

### C. Determining the Cost of Purchases

- Explain to the students the section of the income statement of a merchandising business that computes the total cost of purchases.



Ask, "If you bought five shirts @ \$30 each over the internet and the shipping charges were an additional \$10 but you had to return one of the shirts because it was the wrong size, what was the **total cost** of your purchases?"

The net delivered cost of purchases for Maxx-Out Sporting Goods for January is calculated as follows.	
Purchases	\$23,315
Freight In	1,565
Delivered Cost of Purchases	\$24,880
Less Purchases Returns and Allowances	476
Less Purchases Discounts	124
Net Delivered Cost of Purchases	\$24,280

Purchases (5 x \$30)	\$150
+ Freight In	<u>10</u>
= Delivered Cost of Purchases	160
- Less Purchase Returns and allowances	<u>30</u>
= Net delivered cost of purchases	<u>\$130</u>

(In the example above, there were no purchases discounts. If there were they would be subtracted to arrive at the net delivered cost of purchases.)

- **TEACHING TIP:** Test your students understanding of the section by writing the following true/false items on the board or a transparency.

1. Purchases is a balance sheet account.  
(False)

Chapter 8

### Accounting for Purchases, Accounts Payable and Cash Payments

**Section 2: Accounts Payable**

**Section Objectives**

- 8.3 Post from the general journal to the general ledger accounts.
- 8.4 Post transactions to the accounts payable subsidiary ledger.
- 8.5 Prepare a schedule of accounts payable.
- 8.6 Demonstrate a knowledge of the procedures for effective internal control of purchases.
- 8.7 Record purchases, sales, returns, cash payments, and cash receipts using the perpetual inventory system.

#### Accounts Payable

##### Recording Merchandise Purchased with a Trade Discount

- International Sportsman offers merchandise for sale with a list price of \$1,000, with trade discounts of 20 percent and 10 percent, terms 2/10, n/30.
- Maxx-Out Sporting Goods purchases merchandise with a list price from International Sportsman, Invoice 5201.
- The amount owed for the purchase is computed as follows:

List price	\$1,000.00
Less first discount (\$1,000 × 20%)	200.00
Difference	\$ 800.00
Less second discount (\$800 × 10%)	80.00
Invoice price	\$ 720.00

##### Recording Merchandise Purchased with a Trade Discount

GENERAL JOURNAL						DATE	POST	DEBIT	CREDIT
DATE	DESCRIPTION	POST	DEBIT	CREDIT					
1/28	20 Purchases		720.00						
	Accounts Payable			720.00					
	Purchase Discounts			40.00					
	Cash			20.00					
	Add balance owed to Maxx-Out Sporting Goods			720.00					
	Invoice 5201, Check 282								

GENERAL JOURNAL						DATE	POST	DEBIT	CREDIT
DATE	DESCRIPTION	POST	DEBIT	CREDIT					
1/28	20 Accounts Payable		720.00						
	Purchase Discounts			40.00					
	Cash			20.00					
	Add balance owed to Maxx-Out Sporting Goods			720.00					
	Invoice 5201, Check 282								

**Objective 8-3** Post from the general journal to the general ledger accounts.

- Posting to the general ledger is done in the same manner as demonstrated in Chapter 4.

2. The terms 2/10, net 45 mean that a business can take a 2% cash discount on its purchase if it pays the invoice within 10 days. (True)
3. *Freight In* is a selling expense for the business that purchases the item. (False)
4. You post from a *General journal* to the *General Ledger* at the end of the month. (False)

## Section 2. ACCOUNTS PAYABLE

### Objective 8-3

#### ◆ Post from the general journal to the general ledger accounts

- There are no column totals in a general journal.
- Each journal entry should be posted to the general ledger accounts daily.

## ◆ Recording Merchandise Purchased with a Trade Discount

- Explain students that certain businesses offer goods to trade customers with the price computed using trade discounts.

### A. The Accounts Payable Ledger

- Explain that many businesses use an accounts payable subsidiary ledger to track amounts owed, to whom they are owed, when they are due, and discount terms. This ensures that the firm will have enough cash to pay for obligations.

Objective 8-4 Post transactions to the accounts payable subsidiary ledger.

**The Accounts Payable Ledger**

NAME: *Protein Spectrometers* TERMS: *2/10*  
ADDRESS: *2718 Sherry Lane, Suite, CA 92782*

DATE	DESCRIPTION	DEBIT	CREDIT	BALANCE
2014				
Jan. 1	Balance			1,800.00
Jan. 20	Invoice #201	20	1,780.00	1,800.00

- The accounts payable ledger has three money columns.
- The balance column is presumed to contain credit amounts.

Posting to the subsidiary ledger:

**GENERAL JOURNAL**

DATE	DESCRIPTION	DEBIT	CREDIT	BALANCE
2014				
Jan. 20	Accounts Payable/Protein Spectrometers	1,780.00		
	Protein Spectrometers		1,780.00	
	Purchase Discounts	20.00		
	Cash		1,800.00	
	Paid Invoice #201 to Protein Spectrometers		1,800.00	
	Protein Spectrometers		1,800.00	
	Invoice #201, Check 112		1,800.00	

NAME: *Protein Spectrometers* TERMS: *2/10*  
ADDRESS: *2718 Sherry Lane, Suite, CA 92782*

DATE	DESCRIPTION	DEBIT	CREDIT	BALANCE
2014				
Jan. 1	Balance			1,800.00
Jan. 20	Invoice #201	20	1,780.00	1,800.00

## Objective 8-4

### ◆ Post transactions to the accounts payable subsidiary ledger.

- To keep the accounting records up to date, invoices are posted to the Accounts Payable Subsidiary Ledger every day.
- Review how to post from the general journal to the *Accounts Payable Subsidiary ledger*.
- Notice that the balance column does not indicate whether the balance is a debit or a credit because it is presumed to contain credit amounts.

- Remind students that a ✓ in the post ref. Column indicates that a subsidiary ledger account was updated.



Ask, "What does the J2 in the *Post. Ref. Column* represent?" Page Number of **General Journal**

- Remind students that if a return is recorded in the General Journal, then posting to both the general ledger and the subsidiary ledger would need to be done at the end of the day.
- Indicate that the subsidiary ledger for the vendor always needs to be updated on the day of the return.

**Objective 8-5 Prepare a schedule of accounts payable**

- The total of the individual creditor accounts in the subsidiary ledger must equal the balance of the Accounts Payable control account.
- To prove that the control account and the subsidiary ledger are equal, businesses prepare a schedule of accounts payable.

### Objective 8-5

- ◆ **Prepare a schedule of accounts payable**

## B. Schedule of Accounts Payable

- Point out the figure in the text that shows individual account balances for three suppliers/creditors of Maxx-Out Sporting Goods.

**Schedule of Accounts Payable**

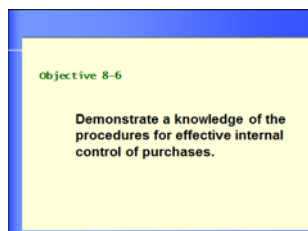
Maxx-Out Sporting Goods  
Schedule of Accounts Payable  
January 31, 2018

Active Jerseys	1,200.00
Athletic Equipment, Inc.	4,200.00
Modern Sportswear	1,800.00
Total	<u>7,200.00</u>



Ask, "Based on the terms of the purchase, which of the suppliers should the business pay early?" **The ones that give a cash discount.**

- Then refer to the *Schedule of Accounts Payable* of Maxx-Out Sporting Goods on January 31 and the *Accounts Payable* controlling account. It displays the balances of the three vendor/creditor accounts in a *Schedule of Accounts Payable* and shows the activity in the *Accounts Payable* general ledger account.
- Emphasize that the schedule of accounts payable is particularly important to a business owner or accounts payable manager in keeping track of how much money the company owes and when that amount is due.



### Objective 8-6

- ◆ **Demonstrate knowledge of the procedures for effective internal control of purchases**

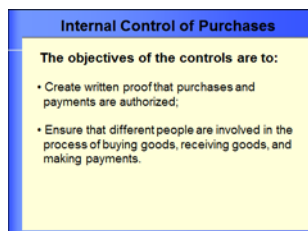
## C. Internal Control of Purchases

- Explain to students that it is important to control all phases of purchasing; ordering, receiving, and retailing.



Ask, "Have you ever worked any place where you knew people were stealing from the company?"

- Explain that with the proper internal controls in place, businesses have a better chance of safeguarding their assets.
- Review the Internal controls/procedures listed in the chapter.



**Internal Control of Purchases**

Effective systems have the following controls in place

1. All purchases should be made only after proper authorization has been given in writing.

**Internal Control of Purchases**

4. The computations on the invoice should be checked for accuracy.
5. Authorization for payment should be made by someone other than the person who ordered the goods, and this authorization should be given only after all the verifications have been made.
6. Another person should write the check for payment.

**Internal Control of Purchases**

7. Prenumbered forms should be used for purchase requisitions, purchase orders, and checks. Periodically the numbers of the documents issued should be verified to make sure that all forms can be accounted for.

**Objective 8-7**

**Record purchases, sales, returns, cash payments, and cash receipts using the perpetual inventory system.**

**The Perpetual Inventory System**

- When the perpetual system is used, an account called Merchandise Inventory replaces all purchase related accounts.
- Additionally, perpetual inventory accounting requires a second entry when sales are made.
- Summarized journal entries using both systems are summarized on the next few slides.

- Point out that the person controlling the accounting functions must devise forms such as physical-flow-of-goods charts and assigning responsibility for tracking all phases of each purchase.
- Emphasize that a separation of duties between employees maximizes good internal control because it makes it difficult for employees to collude together in order to steal from the company.
- Explain the objectives of internal control system.

### Objective 8-7

## **D. Perpetual Inventory Accounting**

- ◆ **Record purchases, sales returns, cash payments, and cash receipts using the perpetual inventory system.**
- So far in chapters 7 and 8, we have assumed the use of a periodic inventory system, where physical inventories are only updated when a physical inventory is taken.
- Larger businesses may require up to date information of inventories on hand, and use the perpetual inventory system.
- When the perpetual inventory system is used, an account called merchandise inventory replaces the purchases, purchases returns and freight in accounts used in the periodic system.
- Merchandise Inventory is an asset account whose balance represents the cost of merchandise inventory on hand.

Purchases - Perpetual Inventory System			
Journal Entry to Record Transactions, Using the			
Transaction	Perpetual System	Perpetual System	
July 20 Purchased merchandise on account for \$2,200 plus freight of \$20 from Smith's Wholesale. Invoice #202. Payment on 7/21, C.O.D.	Purchases 2,200 Freight In 20 Accounts Payable/Smith's Wholesale 2,220	Merchandise Inventory 2,220 Accounts Payable/Smith's Wholesale 2,220	
July 22 Received Cash Receipt #108 for \$100 from Smith's Wholesale for defective product returned. The amount is credited to the account.	Accounts Payable/Smith's Wholesale 100 Cash 100	Accounts Payable/Smith's Wholesale 100 Cash 100	
July 23 Merchandise on hand is counted. Company's book balance is \$1,200, and \$170, C.O.D. The cost of the merchandise returned is \$80.	Accounts Payable/Smith's Wholesale 170 Cash 170	Accounts Payable/Smith's Wholesale 170 Cash 170	
July 24 Received Cash Receipt #109 for \$100 from Smith's Wholesale for defective product returned. The amount is credited to the account.	Accounts Payable/Smith's Wholesale 100 Cash 100	Accounts Payable/Smith's Wholesale 100 Cash 100	

Payments - Perpetual Inventory System			
Journal Entry to Record Transactions, Using the			
Transaction	Perpetual System	Perpetual System	
July 11 Received Cash Receipt #107 for \$1,000 from Smith's Wholesale for merchandise returned. The amount is credited to the account.	Accounts Payable/Smith's Wholesale 1,000 Cash 1,000	Accounts Payable/Smith's Wholesale 1,000 Cash 1,000	
July 14 Received Cash Receipt #108 for \$100 from Smith's Wholesale for defective product returned. The amount is credited to the account.	Accounts Payable/Smith's Wholesale 100 Cash 100	Accounts Payable/Smith's Wholesale 100 Cash 100	

- Additionally, perpetual inventory methods use an account called Cost of Goods Sold. There are two journal entries required when merchandise is sold; one to record the revenue and another to record the related expense.
- The Cost of Goods Sold Account shows the actual cost of the merchandise sold to customers.
- Cost of Goods Sold is classified as an expense on the Income Statement.

### Managerial Implications



Ask, "Can you think of any important accounting controls or rules that you would have in your business?"

**Answer—Students should recognize the need for check and balances for avoiding theft and waste.**

### Section Wrap-up

Write T accounts on the board for *Purchases*, *Purchase Discounts*, and *Purchase Returns and Allowances*.

Call on students to tell you the rules of debit and credit and the normal balances for each account.