**UNIT 7**

**Accounting Cycle**

**Meaning of Accounting Cycle**

An accounting cycle is a complete sequence of accounting process that begins with the recording of business transactions and ends with the preparation of final accounts.

**Accounting Cycle**

When a businessman starts his business activities, he records the day-to-day transactions in the Journal. From the journal the transactions move further to the ledger where accounts are written up. Here, the combined effect of debit and credit pertaining to each account is arrived at in the form of balances. To prove the accuracy of the work done, these balances are transferred to a statement called trial balance. Preparation of trading and profit and loss account is the next step. The balancing of profit and loss account gives the net result of the business transactions. To know the financial position of the business concern balance sheet is prepared at the end.

These transactions which have completed the current accounting year, once again come to the starting point – the journal – and they move with new transactions of the next year. Thus, this **cyclic** **movement of the transactions through the books of accounts** **(accounting cycle) is a continuous process**.

**Q.1.** What is an Accounting Cycle?

**Answer:** An accounting cycle is a complete sequence of accounting process that begins with the recording of business transactions and ends with the preparation of final accounts.

**Q.2.** What are the steps in an Accounting cycle?

**Answer:** Steps in an Accounting cycle are as follows

* Balance Sheet (Opening)
* Transactions
* Journal
* Ledger
* Trial Balance
* Trading Account
* Profit and Loss Account
* Balance Sheet (Closing)

**Accounting for Merchandising Companies**

**Meaning of Merchandising Company**

A merchandising business is one that buys and sells goods in order to make a profit.

**Merchandise**

The goods that a company buys in order to resell are known as merchandise.

**Accounting for Merchandise**

Merchandise may be accounted for under one of two inventory methods:

* Perpetual Inventory
* Periodic Inventory

For this chapter, we will assume a perpetual inventory system.

**Merchandise Transactions**

Several types of transactions are common for merchandising companies:

Purchase of Merchandise

Sale of Merchandise

Purchase Return

Sales Return

Payment on Account

Receipt on Account

**Purchase of Merchandise**

Before it can be sold, Merchandise must be purchased. The seller of merchandise is more commonly known as the vendor.

The source document for a purchase of merchandise is the purchase invoice.

**Purchase of Merchandise**

Ali Career Consulting purchased 24 books from XYZ Publishing to resell to clients. The total purchase cost, including shipping, was SR. 265. The books were purchased on account.

The journal entry to record this transaction in a perpetual inventory system is as follows.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Merchandise Inventory Dr.  To Accounts Payable-XYZ Pub |  | 265 | 265 |

**Purchase Returns & Allowances**

Sometimes merchandise must be returned to the vendor or an adjustment is made to the amount due for the merchandise (allowance).

The source document for a purchase return or allowance is the debit memorandum.

**Effect of Purchase Returns & Allowances**

When a return is made or an allowance is granted for merchandise bought on account, the effect of the transaction is to reduce the amount due to the Vendor (Accounts Payable) and to reduce the value of Merchandise Inventory.

**Journal Entry for a Purchase Return**

Ali Career Consulting returned 4 damaged books to XYZ Publishing. The total value of the merchandise returned was SR. 50.

The journal entry to record this transaction in a perpetual inventory system is as follows.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Payable-XYZ Pub Dr.  To Merchandise Inventory |  | 50 | 50 |

**Journal Entry for a Purchase Allowance**

The most typical reason for a purchase allowance is damaged merchandise.

The journal entry to record a purchase allowance is the same as the entry to record a purchase return.

Assume that Ali Career Consulting discarded the 4 damaged books and received an allowance from the vendor.

The journal entry would be the same as the previous transaction as shown below.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Payable-XYZ Pub Dr.  To Merchandise Inventory |  | 50 | 50 |

**Purchase Discounts**

Merchandise is often purchased on account. When this occurs, the business and the vendor must agree on the credit terms. The credit terms determine when the invoice must be paid.

Many vendors offer a discount if the invoice is paid within a specified period of time that is less than the full credit term.

Discount terms are stated in the following way 2/10, n/30

This term is read “Two ten, net thirty” and means that the buyer will receive a 2 percent discount on the purchase price if the invoice is paid within ten days of the invoice date; else the total (net) is due within thirty days.

Other discount terms include

1/15, n/30 and 3/10, n/45

**Calculating a Purchase Discount**

The credit terms for this invoice indicate that if this invoice is paid by June 25 (10 days after the invoice date), the buyer may take a 2% discount on the merchandise price. Otherwise, the total amount due (SR. 265.00) must be paid by July 15.

Examine this invoice

|  |
| --- |
| **Invoice**  Date: 15/06/14  Terms: 2/10, n/30  Purchase of 20 books at  SR. 12.50 SR.250.00  Shipping 15.00  Total Due SR.265.00 |

NOTE: Discounts are calculated on the merchandise cost only.

If this invoice is paid on June 15, the amount due would be SR.260.00. The discount of SR. 5.00 (SR. 250.00 \* .02) is deducted from the total due in determining the amount to pay.

**Journal Entry for Payment with a Purchase Discount**

A compound entry is required to journalize the entry to record payment of an invoice when the discount is taken.

Assume that Ali Career Consulting pays the invoice of 15/06/14 on 22/06/14. Further assume that no merchandise has ever been returned or granted an allowance.

The journal entry to record the payment of the invoice is as follows.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Payable-XYZ Pub Dr.  To Cash  To Merchandise Inventory |  | 265 | 260  5 |

**Affect of Discount on Accounts Payable**

Notice that Accounts Payable is debited for SR. 265 even though the company was paid only SR. 260. If Accounts Payable were not debited for the full amount of the invoice, a balance of SR. 5 would remain in this account. When a discount is granted, the purchaser pays the amount of the invoice less the discount but is given credit by the creditor for the full amount.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Payable-XYZ Pub Dr.  To Cash  To Merchandise Inventory |  | 265 | 260  5 |

**Affect of Discount on Merchandise Inventory**

Notice that the purchase discount is deducted directly from the Merchandise Inventory account. The affect of a purchase discount is to reduce the cost of the merchandise purchased. This is accomplished in the journal entry by crediting Merchandise Inventory.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Payable-XYZ Pub Dr.  To Cash  To Merchandise Inventory |  | 265 | 260  5 |

**Journal Entry for Payment with a Purchase Discount**

Now examine the journal entry when the allowance for the four books is taken into account.

Notice that the discount cannot be calculated on the amount of the returned merchandise and the balance of Accounts Payable has been reduced by the amount of the return.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Payable-XYZ Pub Dr.  To Cash  To Merchandise Inventory |  | 215 | 211  4 |

**Explanation of the Calculation of the Payment amount with a Purchase Discount and Allowance**

In order to calculate the amount due on the invoice, first deduct the amount of the purchase allowance.

|  |
| --- |
| Original Invoice Less Allowance Net Due  SR. 265 - SR. 50 = SR. 215 |

Next, deduct the shipping cost in order to determine the amount of the discount.

|  |
| --- |
| Net Due Less Shipping Times Discount Rate Discount SR. 215 - SR. 15 X .02 = SR.4 |

The total due to XYZ is SR. 211 (SR. 215 less the SR. 4 discount).

**Sale of Merchandise**

The purpose of buying merchandise is to resell it, generally at a profit.

The source document for a sale of merchandise is the sales invoice.

**Recording the Sale of Merchandise**

Two journal entries are required to record the sale of merchandise in a perpetual inventory system--

1. The first entry records the sale of the merchandise and either the receipt of cash or the account receivable. The amount used in this transaction is the sales price of the merchandise.
2. The second entry records the reduction in merchandise and the recognition of an expense for the cost of merchandise sold. The amount used in this transaction is the cost of the merchandise.

**Journal Entry for a Sale of Merchandise**

Ali Career Consulting sold 2 books to Abdul on account for a total of SR. 50. The total cost of the books sold was SR. 25.

The journal entries to record this transaction in a perpetual inventory system are as follows.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Accounts Receivable-Abdul Dr.  To Sales  Cost of Merchandise Sold Dr.  To Merchandise Inventory |  | 50  25 | 50  25 |

**Sales Returns & Allowances**

Just as merchandise is sometimes returned to the vendor or an adjustmentis made to the amount due for the merchandise (allowance), the seller must sometimes account for a sale return or allowance.

The source document for a sales return or allowance is the credit memorandum.

**Recording a Sales Return or Allowance**

Recall that two journal entries are required to record the sale of merchandise in a perpetual inventory system. Two journal entries are also required to record a sales return or allowance.

1. The first entry recognizes the sales return or allowance and either the payment of cash or the reduction of the account receivable. The amount used in this transaction is the sales price of the merchandise returned or adjusted.

2. The second entry records the replacement of the merchandise in inventory and the reduction of the expense for the cost of merchandise sold. The amount used in this transaction is the cost of the merchandise.

**Recording a Sales Return or Allowance**

The essential affect of the journal entries to record a sales return or allowance is to reverse the original entry to record the sale—it is as if the merchandise was never sold.

The only difference is that instead of reducing the Sales account, the amount of returns and allowances are kept up with in the Sales Returns & Allowances account.

**Journal Entry for a** **Sales Return or Allowance**

Abdul returned one book. The book had been sold by Ali Career Consulting for SR. 25. The cost of the book was SR.12.50.

The journal entries to record this transaction in a perpetual inventory system are as follows.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Date** | **Particulars** | **L.F.** | **Amount (Dr.)** | **Amount (Cr.)** |
|  | Sales Returns & Allowances Dr.  To Accounts Receivable-Abdul  Merchandise Inventory Dr.  To Cost of Merchandise Sold |  | 25.00  12.50 | 25.00  12.50 |

**MULTIPLE CHOICE QUESTIONS**

**1**. The difference between net sales and cost of merchandise sold for a merchandising business is:

a) Sales

b) Net Sales

c) Gross Profit

d) Gross Sales

2. When purchases of merchandise are made on account, the transaction would be recorded with the following entry:

a) Debit Accounts Payable, credit Merchandise Inventory

b) Debit Merchandise Inventory, credit Accounts Payable

c) Debit Merchandise Inventory, credit Cash

d) Debit Cash, credit Merchandise Inventory

3. Merchandise with an invoice price of SR. 7,000 is purchased with terms of 2/10, n/30,. Transportation costs paid by the seller were SR. 125. What is the cost of the merchandise purchased if payment is made during the discount period?

a) SR. 6,860.00

b) SR. 6,982.50

c) SR. 7,000.00

d) SR. 6,985.00

4. Cost of Merchandise Sold would be classified as:

a) Asset

b) Expense

c) Liability

d) Revenue

5. The discount period for credit terms of 1/10, n/30 is:

a) 1 day

b) 10 days

c) 20 days

d) 30 days

6. Freight costs incurred by the seller are recorded in the

a) Sales account

b) Cost of merchandise sold account

c) Transportation In account

d) Transportation Out account

7. Which of the following would be classified in an income statement as Other Income or Other Expense?

a) Advertising Expense

b) Interest Expense

c) Transportation Out

d) Cost of merchandise sold

8. The sales discount is based on

a) Invoice price plus transportation costs

b) Invoice price less discount

c) Invoice price plus transportation costs less returns and allowances

d) Invoice price less returns and allowances

9. In a perpetual inventory system, what accounts are credited when a customer returns merchandise to the seller?

a. Sales Returns and Allowances and Accounts Receivable

b. Accounts Receivable and Cost of Merchandise Sold

c. Merchandise Inventory and Cost of Merchandise Sold

d. Sales Returns and Allowances and Merchandise Inventory

10. Which of the following accounts is credited by the seller when merchandise purchases are paid for within the discount period?

a) Merchandise Inventory

b) Accounts Payable

c) Accounts Receivable

d) Sales Discounts

11. A classified balance sheet reports merchandise inventory as:

a) Plant asset

b) Long-term asset

c) Current asset

d) Current liability

12. Gross Margin is calculated as:

a) Sales less cost of merchandise sold

b) Sales less merchandise inventory

c) Sales less expenses

d) Sales less operating expenses

**(ANSWER 1. C, 2. B, 3. D, 4. B, 5. B, 6. D, 7. B, 8. D, 9. B, 10. C, 11. C, 12. A,)**

**True / False Questions**

1. Trade discounts represent a discount offered to the purchasers for quick payment.

True False

**Answer. False -** trade discounts represent a reduction in the listed price of a product or service.

2. When a company sells a $100 service with a 20% trade discount, $80 of revenue is recognized.

True False

**Answer. True**

3. A sales discount represents a reduction, not in the selling price of a product or service, but in the amount to be paid by a credit customer if payment is made within a specified period of time.

True False

**Answer. True**

4. A sale on account for SR. 1,000 offered with terms 2/10, n/30 means that the customers will get a SR. 2 discount if payment is made within 10 days; otherwise, full payment is due within 30 days.

True False

**Answer. False -** 2/10 indicates a 2% discount (or SR. 20 in this example) if payment is made within 10 days.

5. The Sales Discounts account is an expense account.

True False

**Answer. False -** sales Discounts is a contra revenue account.

6. A sales allowance is recorded as a debit to Accounts Receivable and a credit to Sales Allowances.

True False

**Answer. False -** a sales allowance is recorded as a debit to Sales Allowances and a credit to Accounts Receivable.

7. The Sales Returns account is an expense account.

True False

**Answer. False -** sales Returns is a contra revenue account.

8. If a company has total revenues of SR. 100,000, sales discounts of SR. 3,000, sales returns of SR. 4,000, and sales allowances of SR. 2,000, the income statement will report net revenues of SR. 91,000.

True False

**Answer. True**

9. Cost of goods sold is an asset reported in the balance sheet and inventory is an expense reported in the income statement.

True False

**Answer. False -** cost of goods sold is an expense reported in the income statement and inventory is an asset reported in the balance sheet.

10. If a company has beginning inventory of SR. 15,000, purchases during the year of SR. 75,000, and ending inventory of SR. 20,000, cost of goods sold equals SR. 70,000.

True False

**Answer. True**

11. For inventory that is shipped FOB destination, title transfers from the seller to the buyer once the seller ships the inventory.

True False

**Answer. False** - For FOB destination, title transfers once the inventory reaches the buyer (destination).

FOB is only used in Sea Freight and stands for "Free On Board",. Indicating "FOB port" means that the seller pays for transportation of the goods to the port of shipment, plus loading costs. The buyer pays cost of [marine freight](http://en.wikipedia.org/wiki/Cargo) transport, [insurance](http://en.wikipedia.org/wiki/Insurance), unloading, and transportation from the arrival port to the final destination.

12. For inventory that is shipped FOB shipping point, title transfers from the seller to the buyer once the seller ships the inventory.

True False

**Answer. True**

13. Freight-in is included in the cost of inventory.

True False

**Answer. True**

14. Gross profit equals net sales of inventory less cost of goods sold.

True False

**Answer. True**

15. Sales revenue minus cost of goods sold is referred to as operating income.

True False

**Answer. False** - sales revenue minus cost of goods sold equals gross profit.

16. When a company sells a SR. 100 service with a 20% trade discount, SR. 80 of revenue is recognized.

True False

**Answer. True**

17. Sales returns and allowances occur when the buyer returns the goods or the seller reduces the customer's balance owed.

True False

**Answer. True**

18. Inventory is usually reported as a long-term asset in the balance sheet.

True False

**Answer. False** - inventory is typically reported as a current asset because companies expect to convert it to cash in the near term.

19. Merchandising companies purchase inventories that are primarily in finished form for resale to customers.

True False

**Answer.**  **True**

20. Sales revenue minus cost of goods sold is referred to as operating income.

True False

**Answer. False** - sales revenue minus cost of goods sold equals gross profit.

21. Income before income taxes equals operating income plus non operating revenues less non operating expenses.

True False

**Answer.**   **True**