ACCT 100 - Intro to Acct.

Chapter 8 - Accounting for Purchases, A/P, and Cash Payments

Prof. Johnson

Where we have been: Last time we started our discussion for merchandising entities and focused on the selling side of the house. We discussed the different types of sales that take place for merchandising entities, and learned to record all of them using the general journal. We also discussed the importance of keeping track of detailed customer transactions and learned how the A/R subsidiary ledger could help us do this. Finally, we learned how to post transactions and how to balance the A/R ledger to the A/R controlling account through the use of a schedule of Accounts Receivable.

Where we are going: Now we turn to the other side of the house for merchandisers -- the purchasing process and tracking what we owe to our vendors. We will learn to record purchases transactions in the journal, how to compute parts of the income statement related to purchases, and how to track amounts due to our vendors. We will also briefly discuss internal control procedures for the effective control of purchases.

The Purchasing Function:

As we discussed last time, a merchandiser has two basic functions: to buy and to sell. Last time we discussed the sales process and learned how to record sales of merchandise in the journal. Today, we switch to the other side of the house: The buying side. There are many new terms to learn. Remember that whenever we learn about new accounts, you should focus on three things. (1) The type of account it is and what it's used for, (2) the normal balance of the account, and (3) what financial statement the account goes on. Some of the accounts are listed below for introductory purposes.

Purchases - Used to record all purchases of merchandise for resale, this is one of the largest expense accounts of a merchandiser. It is classified as a cost of goods sold account. The cost of goods sold calculation, that we will discuss later, measures the actual cost to the business of the merchandise sold to customers. Like all expenses, this one has a normal debit balances, and will be shown on the income statement. It may be offset with contra accounts (described later.)

Freight In or **Transportation In** - Freight costs are significant to merchandisers. This account is an expense account. It will show up on the income statement. This account tracks the freight on incoming merchandise that we will resell. (There are also "shipping terms" that you will need to become familiar with.)

Merchandise Inventory - This represents the stock of goods on hand at the end of the fiscal year. Don't touch this account during the accounting cycle. We will talk more about it later. It will be adjusted at year end when a physical year end count is taken. We will use this account more in Chapters 12 and 13.

Just as there are some **contra accounts** on the selling side, there are also some contra expenses (or contra purchases) accounts on the buying side.

Here they are:

Purchases Returns and Allowances - This account is a contra expense, meaning it has a credit balance. It is used track the returns of purchases that we make to vendors. It will be used to reduce the amount of purchases shown on the income statement.

Purchases discounts - Some of our vendors may offer us discounts for quick payments. (Just like we offered them on the selling side.) Terms are usually shown as "fractions" - for example you may see 2/10, net 30. This means that we can take a 2% discount if we pay the full amount in 10 days, otherwise the entire amount without the discount is due in 30 days. This purchases discount account will track the amounts of discounts that we take. This is also a contra expense account, meaning it will have a credit balance.

Determining the Net Delivered Cost of Purchases.

This will be part of the calculation we use in a later chapter when we calculate cost of goods sold. It is important that you learn this calculation in this chapter so that the entire cost of goods sold calculation is not so overwhelming later. Remember that "net" means after deductions -- similar to your "net pay" being your pay after taxes are taken out. So "Net purchases" means the cost of all of the purchases after deductions are taken out.

More about the purchasing process

Most medium to large size firms have fairly large purchasing or procurement departments. These departments are responsible for obtaining the products that are to be sold at competitive prices. There are many documents that are used in the purchasing process. *You should be familiar with these documents and understand* *how they help the internal control of purchases*. Some of the more important ones are as follows:

- A **purchase requisition**
- A **purchase order** (usually referred to as a PO)
- A **shipper** or bill of lading
- A **receiver**
- An **invoice**

Descriptions and examples of each of the above are found in your text. You should be familiar with these documents.

To insure that we got what we ordered, many of these documents are compared to each other to help determine that the merchandise was received and that we have incurred a valid liability. (More about this next semester.)

Some more about Freight Charges:

As briefly discussed freight costs are a significant expense for merchandising firms. Freight in (sometimes called Transportation In at some firms) is debited for freight on incoming merchandise. There are two basic types of shipping terms. They are important to this chapter, but they will become even more important when you discuss the inventory chapter in ACCT 101. They are as follows:

- **FOB Shipping -** This is the most common. This means that the buyer pays the freight costs. It also means that title to the goods passes to the buyer as soon as it leaves the shipper's dock. (That is, the goods are the property of the buyer as soon as the seller gives them to the shipping company. So the buyer assumes title to the goods and also bears the risk of loss during shipment.)
- **FOB Destination -** This is not as common. It means that the seller pays the freight. Title remains with the seller until the goods are delivered to the buyer. Sometimes freight costs are not even disclosed separately, but included in the selling price.

It is also important to note that when goods are shipped FOB Shipping, freight can be either be paid up front by the seller and then billed to the buyer, or the freight charges can be directly billed by the freight company to the buyer.

Prompt payment discounts CANNOT BE TAKEN ON FREIGHT. Make your you consider this when calculating payments to vendors who offer prompt pay cash discounts.

Computing the Net Delivered Cost of Purchases

We are getting ready to prepared a long "multi-step" income statement in a later chapter. In Chapter 7, we learned to compute "Net Sales" which means Sales after the deductions. In this chapter, since we are talking about the "buying side" of the house, we need to learn to compute the Net Delivered Cost of Purchases:

Purchases

<u>Add Freight In</u>

Delivered Cost of Purchases

Less: Purchases returns and allowances

<u>Purchases discounts</u>

Net Delivered Cost of Purchases

It is important that you learn how to compute these components NOW so that the expanded multiple step income statement won't be so overwhelming when we put all the pieces together.

<u>Introducing the AP Subsidiary Ledger</u>

Just as we discussed in the last chapter, the problem the journal is that it does not track balances due to others on an individual level. For this reason, we keep track of amounts owed to our vendors or suppliers by keeping records for each individual company. We do this through the AP subsidiary ledger. This can be likened to a notebook with one page for every vendor. The notebook is usually organized in alphabetical order. It allows us to know how much we owe to the individual suppliers at a glance. The sum of all the balances on the cards in the notebook (the subsidiary ledger) should total up to the controlling account, Accounts Payable in the general ledger when all postings are up-to-date.

Don't forget, because we are tracking individual balances, you must remember that ANYTIME YOU TOUCH AN AP ACCOUNT FROM NOW ON, YOU MUST UPDATE THE VENDOR'S CARD IN THE AP SUBSIDIARY LEDGER. (Many students neglect to do this when entries are made in the general journal for purchases returns and allowances.)

The Balancing Act

To show that the equality exists between the controlling account (AP in the GL) and the sum of the subsidiary accounts, we prepare a **Schedule of Accounts Payable**. Simply take the ending balances for the vendors in the subsidiary ledger, list them on a schedule, add them up, and compare to the total AP balance in the GL

One last thing: Freight charges on non-merchandise items

As discussed above, freight chargers on incoming merchandise are charged to the Freight In account. If you are purchasing a fixed asset such as a computer, or car, or bookcase, GAAP says that the freight charges should be included as part of the cost of the asset.

Basic Internal Control Procedures

Internal Control procedures are put in place to insure that all expenditures are authorized, are for legitimate business purposes, and protected against unauthorized used. A summary of these procedures is located in your book . Please read through them and be able to answer basic questions on a quiz or exam.