Merchandising Financial Statements

by Sophia

WHAT'S COVERED

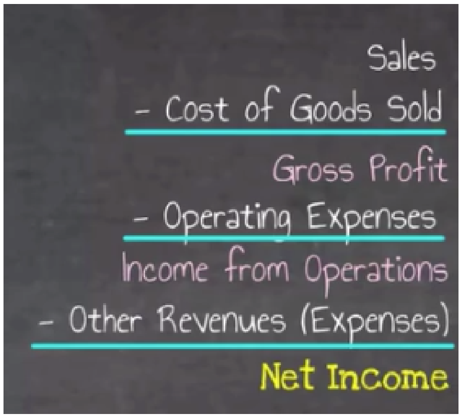
This tutorial will cover a review of financial statements for a merchandising company.

Our discussion breaks down as follows:

1. Income Statement

In review, the income statement is a financial statement that provides information about the revenue, expenses, and net profit or loss of a business for a given time period. The income statement provides information about a business's profitability, generally covering one year or less of activity. It helps to assess the health and strength of a business, which is important information for shareholders, potential investors, and banks.

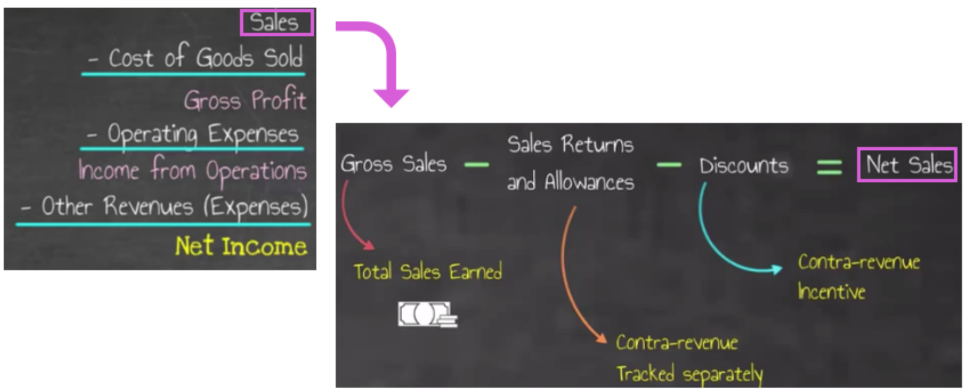
An expanded income statement for a merchandising company starts with sales minus cost of goods sold equals gross profit. We then subtract out operating expenses to provide income from operations, and perform the last step, which is to subtract other expenses or add other revenues to provide net income.



We can break down several components in this expanded income statement further. Let's begin by looking at the expanded sales calculation.

1a. Expanded Sales Calculation

To find the value for sales, starting with gross sales. Then we subtract out sales returns and allowances, and finally subtract out discounts to equal net sales.



- Gross sales are the total sales earned--total cash and total credit sales.
- Sales returns and allowances is a contra-revenue account, meaning it reduces sales. It is tracked separately from sales to preserve our analysis capabilities, so we can compare our sales returns and allowances to our total sales to see what percentage they are, and perform additional analysis.
- Discounts is also a contra-revenue account, meaning it reduces our sales. It's an incentive which can be offered to improve prompt payment or improve total sales. It is also tracked separately.

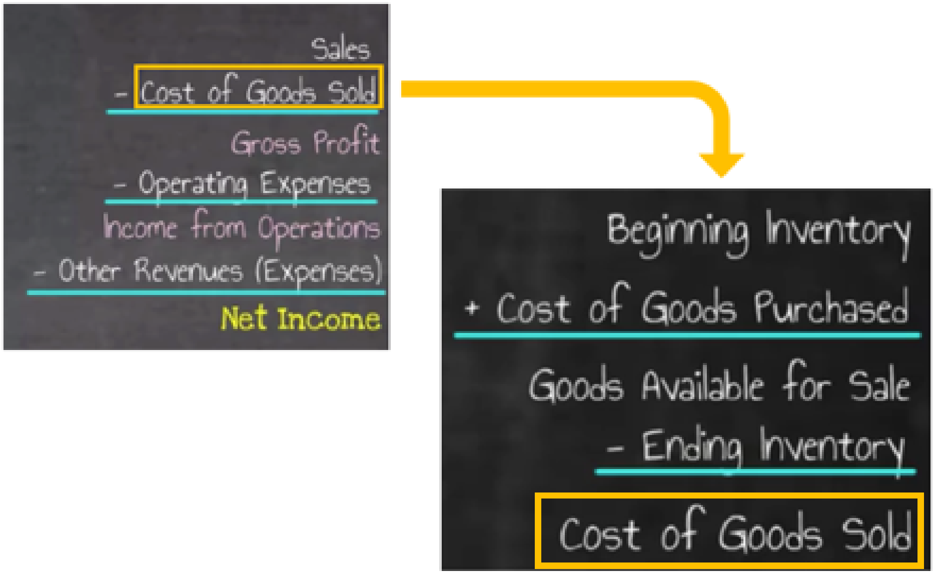
FORMULA TO KNOW

Expanded Sales Calculation

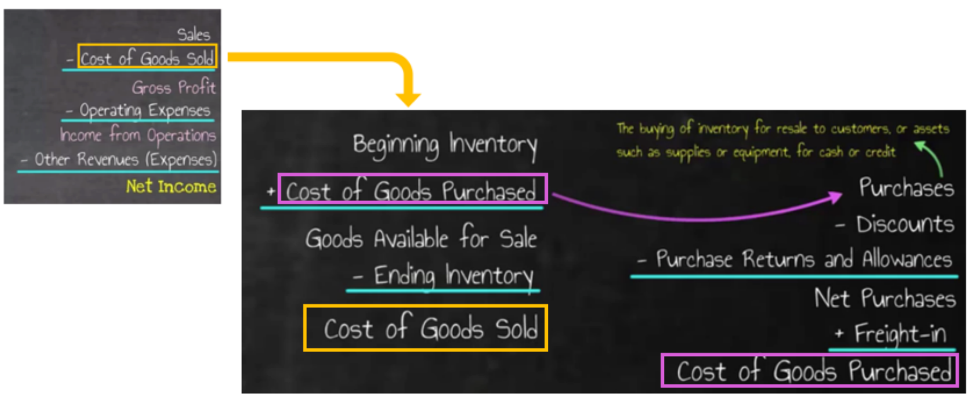
Gross Sales – Sales Returns and Allowances – Discounts = Net Sales

1b. Cost of Goods Sold Calculation

Now, let's explore cost of goods sold in more detail, starting with the expanded cost of goods sold calculation, below. Cost of goods sold starts with beginning inventory and we add cost of goods purchased to give us goods available for sale. We then subtract out ending inventory to provide cost of goods sold.



However, we can go even further by looking at cost of goods. Starting with our purchases, we subtract out discounts, and subtract out purchase returns and allowances to equal net purchases. Next, we add freight-in, which would total the cost of goods purchased. This, in turn, can be plugged into the cost of goods sold calculation.



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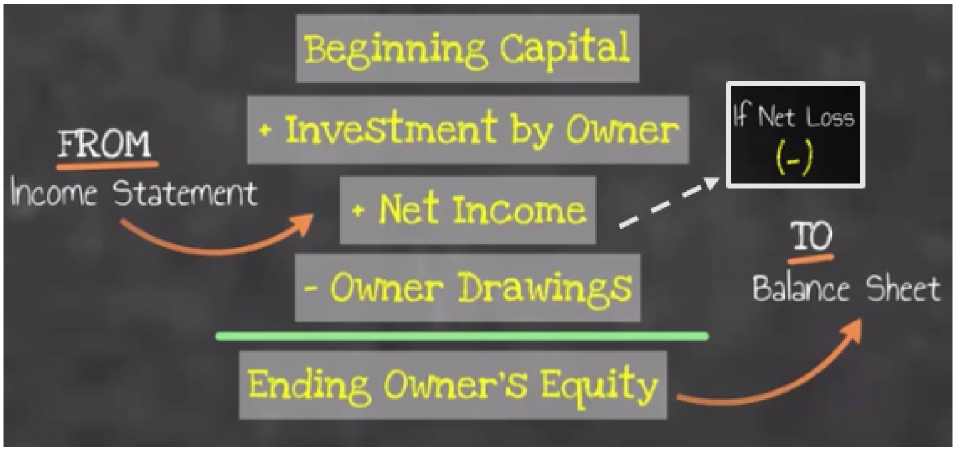
2. Statement of Changes in Owner's Equity

You may recall that the statement of changes in owner's equity is a financial statement that provides information about changes to the equity of a business for a given time period. It provides information about owner's equity similar to the income statement, covering one year or less of owner activity, which refers to any earnings, owner investments, or owner withdrawals.

The formula for the statement of changes in owner's equity starts with the beginning capital, or the beginning balance in owner's equity at the beginning of the year. Then, we add any investments by the owner, plus any net income that the business might have earned, and then subtract owner drawings, meaning any money that the owner or owners pulled out of the business. This results in the ending owner's equity, or the ending balance in the owner's equity account.



Now, if we have a net loss instead of having net income, we would have to subtract the net loss in this formula instead of adding that income. The statement of changes in owner's equity pulls information from the income statement but it also provides information, that ending balance in the owner's equity account, to the balance sheet.

FORMULA TO KNOW

Statement of Changes in Owner's Equity

$$\text{Ending Owner's Equity} = \text{Beginning Capital} + \text{Investment by Owner} + \text{Net Income} - \text{Owner Drawings}$$

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3. Balance Sheet

Now let's review the balance sheet, which is a financial statement that provides information about the assets, liabilities, and equity of a business at a given time.

Think of the balance sheet as the business position. It captures a moment in time, rather than spanning a period, and it is the only financial statement that is prepared at a specific date.

The balance sheet details a business's resources, meaning assets, or the resources owned or available, liabilities owed to others, and the net difference on a cumulative basis, which is the equity.

The accounting equation is a fundamental premise in accounting, which states that a company's assets will be equal to the sum of its liabilities and its equity. This also happens to be the balance sheet formula; the accounting equation and the balance sheet formula are the same.

FORMULA TO KNOW

Accounting Equation/Balance Sheet Formula

$$Assets = Liabilities + Equity$$

Again, the balance sheet provides detailed information about a business's assets and liabilities, as well as equity. As mentioned previously, the balance sheet receives the ending balance in the owner's equity account from the statement of changes in owner's equity. Keep in mind that for a merchandising company, the balance sheet is also going to include information about our inventory, such as LIFO, FIFO, weighted average, etc.

SUMMARY

Today we covered a review of merchandising company financial statements. We reviewed the expanded **income statement**, breaking down its component parts of cost of goods sold and cost of goods purchased. We also reviewed the **statement of changes in owner's equity** and how it pulls information from the expanded income statement. Lastly, we reviewed the **balance sheet** and how it pulls the ending equity balance from the statement of changes in owner's equity.

Source: Adapted from Sophia instructor Evan McLaughlin.