ACC250: Intro to Financial Accounting

Ch6. Merchandising Operations & Multistep Income Statements

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Operating Cycle

The period from the purchase of goods & services to cash collection from customers.

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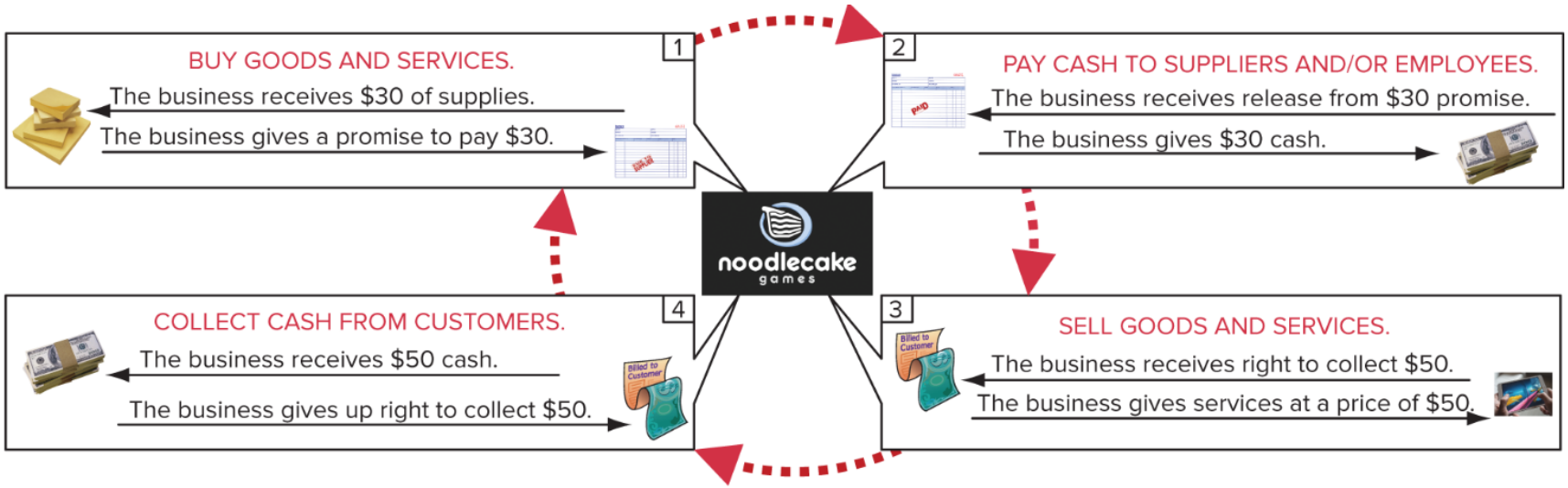


Inventory - Concept

Inventory (Asset)

The total value of the goods held for sale in the ordinary course of business.

Cost Principle

Assets are initially recorded at their **acquisition cost**, which includes all costs necessary to acquire the asset and prepare it for its intended use.

Inventory - Concept

Inventory (Asset)

The total value of the goods held for sale in the ordinary course of business.

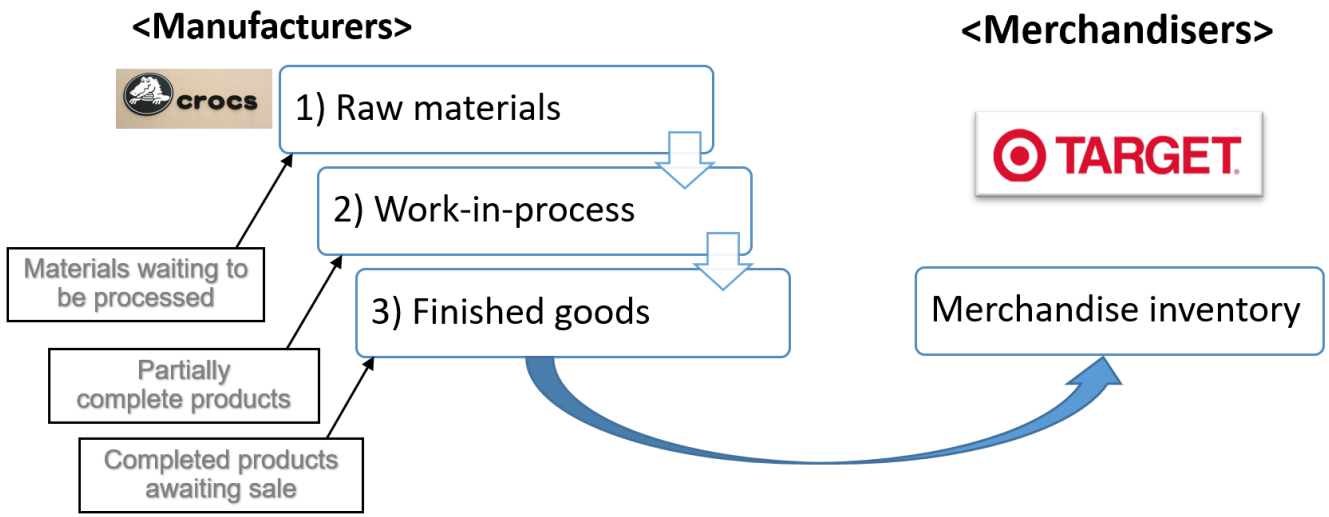
- Inventory is a **current asset**.
- Inventory is recorded at its **cost** (under the **cost principle**).
  (i.e., how much the company paid to acquire the inventory.)

Cost Principle

Assets are initially recorded at their **acquisition cost**, which includes all costs necessary to acquire the asset and prepare it for its intended use.

Inventory - Concept

- For **manufacturing** firms, Inventory is the **raw materials**, **work-in-progress**, and **finished goods**.



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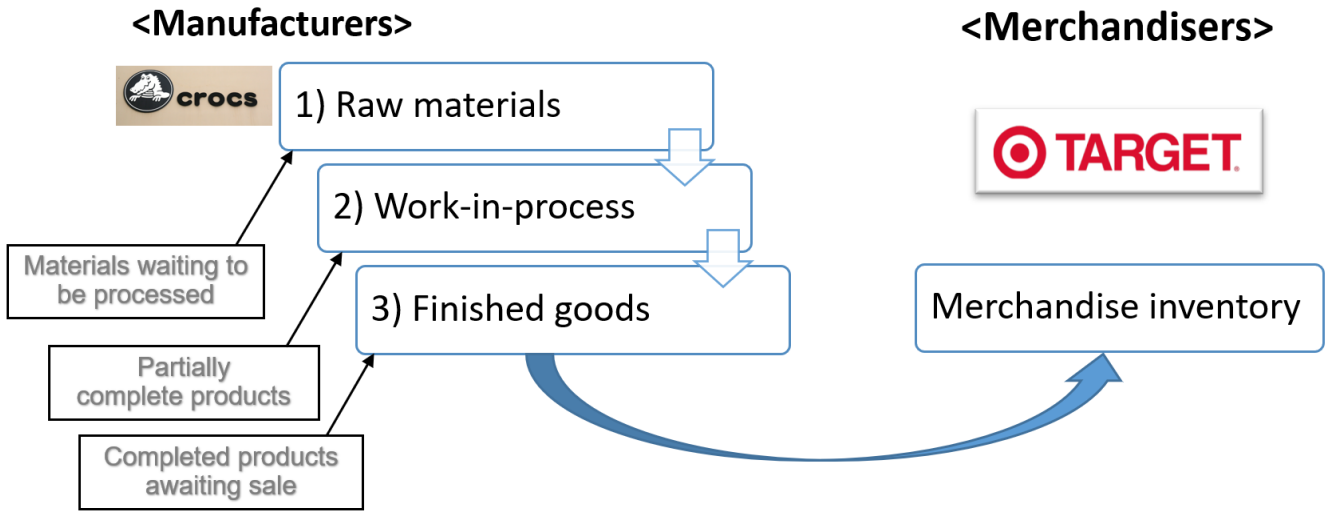
- For **manufacturing** firms, Inventory is the **raw materials**, **work-in-progress**, and **finished goods**.
- For **merchandising** firms, Inventory is the **goods that a company has purchased** but not yet sold.



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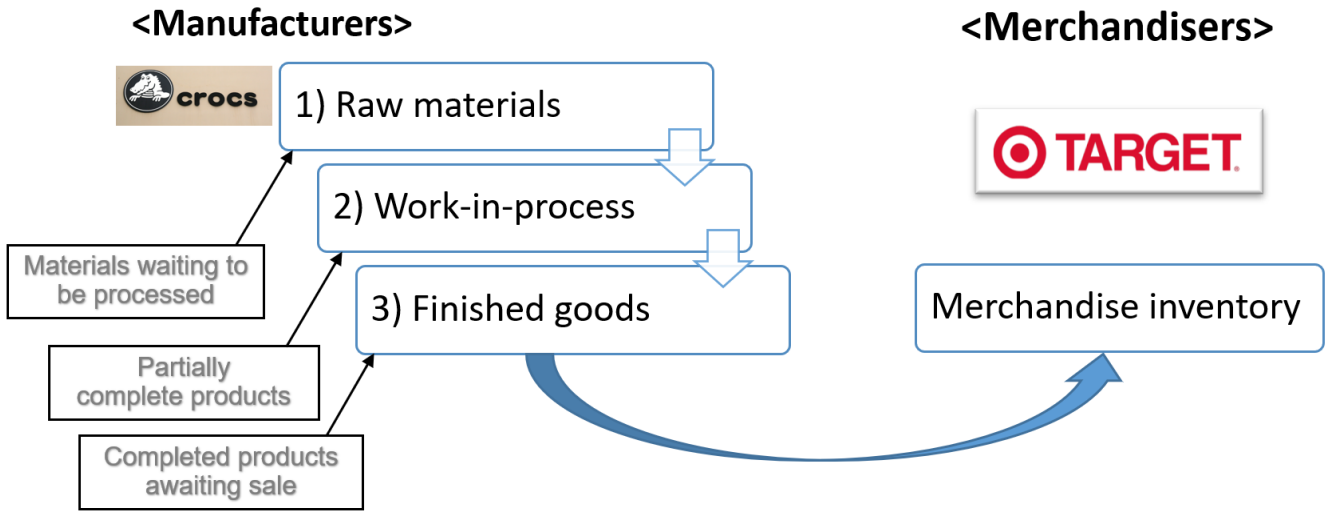

Note: ACC250 focuses on **merchandising** companies (e.g., Amazon, Walmart, Target). ACC255 focuses on **manufacturing** companies (e.g., Apple, Tesla, GM).

Inventory Calculation Example

EX. How much inventory was sold (i.e., **Cost of Goods Sold, COGS**) given the following information?

- At the end of the last year, the inventory balance was \$100.
- In January, your company purchased \$600 additional inventories (i.e., Purchases).
- At the end of January, you found that the inventory balance (i.e., after selling some of it) is \$300.

Answer:

- **Goods available for sale**:
- **Cost of Goods Sold**:

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Answer:

- **Goods available for sale**: $\$100 + \$600 = \$700$
- **Cost of Goods Sold**:

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Answer:

- **Goods available for sale**: \$100 + \$600 = \$700
- **Cost of Goods Sold**: \$700 - \$300 = \$400

Inventory - Equation

Inventory Equation

End. Inventory = Beg. Inventory + Purchases - Cost of Goods Sold

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Inventory is

- increased when purchased;
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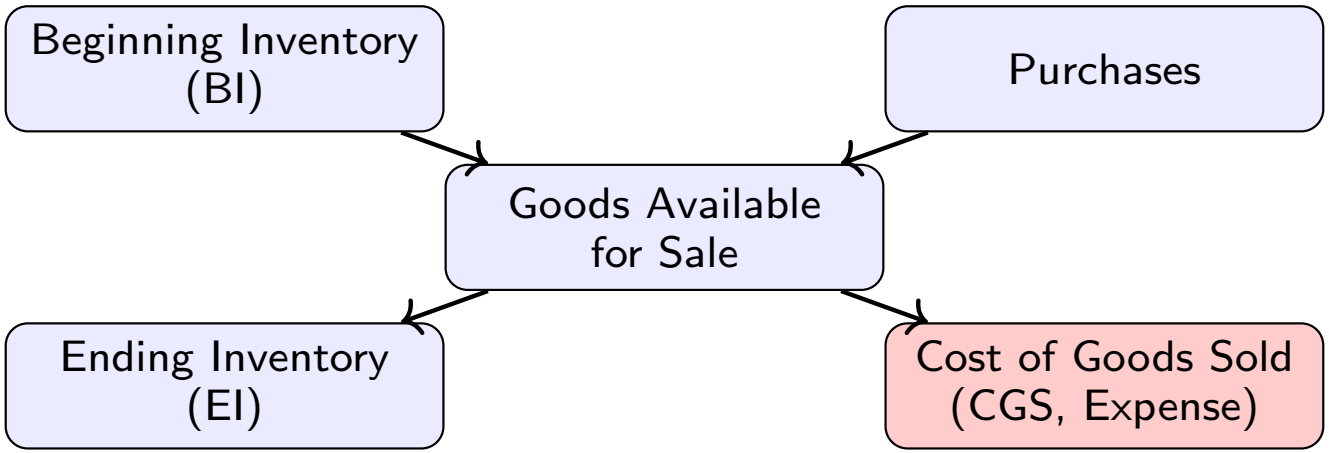

Inventory Equation - to get EI

EX 1. Suppose a company has the following information for the year:

- Beginning Inventory (BI): \$2,000
- Purchases: \$8,500
- Cost of Goods Sold: \$8,200

What is the Ending Inventory (EI) for the year?

- **Goods Available for Sale**:
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- **Goods Available for Sale**: \$2,000 + \$8,500 = \$10,500
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What is the Ending Inventory (EI) for the year?

- **Goods Available for Sale**: \$2,000 + \$8,500 = \$10,500
- **Ending Inventory**: \$10,500 - \$8,200 = \$2,300

Inventory Equation - to get CGS

EX 2. Suppose a company has the following information for the year:

- Beginning Inventory (BI): \$2,000
- Purchases: \$8,500
- Ending Inventory (EI): \$2,300

What is the Cost of Goods Sold (CGS) for the year?[1]

- **Goods Available for Sale**:
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[1] This calculation is required under Periodic Inventory System.

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What is the Cost of Goods Sold (CGS) for the year?[1]

- **Goods Available for Sale**: \$2,000 + \$8,500 = \$10,500
- **Cost of Goods Sold**: \$10,500 - \$2,300 = \$8,200

[1] This calculation is required under Periodic Inventory System.

Inventory vs Supplies

Similarities:

- Both Inventory and Supplies are **assets**.
- Both are **current assets**.
- Both are purchased from **suppliers**.
- Both are usually recorded with **Accounts Payable**.

Difference:

- **Inventory** is the goods that a company has purchased but not yet ____.
- **Supplies** are the goods that a company has purchased but not yet ____.

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Recall: Accounting for Supplies

1. When purchased on account:

2. When supplies are used:

Recall: Accounting for Supplies

1. When purchased on account:

Supplies (+A)	50	
Accounts Payable (+L)		50

2. When supplies are used:

Recall: Accounting for Supplies

1. When purchased on account:

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Accounts Payable (+L)		50

2. When supplies are used:

Supplies Expense (+E, -SE)	50	
Supplies (-A)		50

Accounting for Inventory (with Cost of Goods Sold)

Inventory (Asset)

The total value of the goods held for sale in the ordinary course of business.

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The cost of the goods sold during a period.

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1. Inventory is recorded as an asset.
2. Cash should be paid now or in the future.

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Inventory (+A)	50	
Accounts Payable (+L)		50

Accounting for Inventory (with Cost of Goods Sold)

When the inventory is sold:

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1. Revenues are recorded.

Accounting for Inventory (with Cost of Goods Sold)

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Accounting for Inventory (with Cost of Goods Sold)

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Accounting for Inventory (with Cost of Goods Sold)

When the inventory is sold:

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4. Cost of Goods Sold is recorded (Matching Principle).

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EX. The company sold the inventory for $100 (, purchased for $50) on account:

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EX. The company sold the inventory for \$100 (, purchased for \$50) on account:

Accounts Receivable (+A)	100	
Revenues (+R, +SE)		100

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Cost of Goods Sold (+E, -SE)	50	
Inventory (-A)		50

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The two sets of entries are recorded when the inventory is sold!

Relationship between Assets and Expenses

Assets vs Expenses:

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- Assets are resources that a company owns or controls.
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Assets are turned into expenses when they are used up to generate revenues.

- **Inventory** is turned into **Cost of Goods Sold** when it is sold.
- **Supplies** are turned into **Supplies Expense** when they are used.
- **Equipment** is turned into **Depreciation Expense** when it is used.
- **Prepaid Rent** is turned into **Rent Expense** when it is used.

Accounts Payable Terms (e.g., 2/30, n/60)

Inventory and Accounts Payable:

- Inventory is usually purchased on credit.
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Contractual terms for Accounts Payable (e.g., "**2/30, n/60**" or "**2/30, g/60**"):

- **2/30**: the buyer can get a ____ discount if they pay within ___ days.
- **60**: the buyer should pay the full amount within ___ days without any discount.

Note: The disctinction between "n" vs "g" goes beyond the scope of this course. "n" means "net" method; "g" means "gross" method. **Net method** means that the buyer should pay the full amount without any discount. **Gross method** means that the buyer should pay the full amount with the discount.

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Example

EX 1. A company purchases $5,000 of inventory on account from a supplier with terms **2/30, n/60**. If the company pays the invoice within 30 days, how much should be paid?

EX 2. What if the company pays the invoice 45 days after the purchase?

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$4,900 (after 2% discount)

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EX 2. What if the company pays the invoice 45 days after the purchase?

$5,000 (no discount)

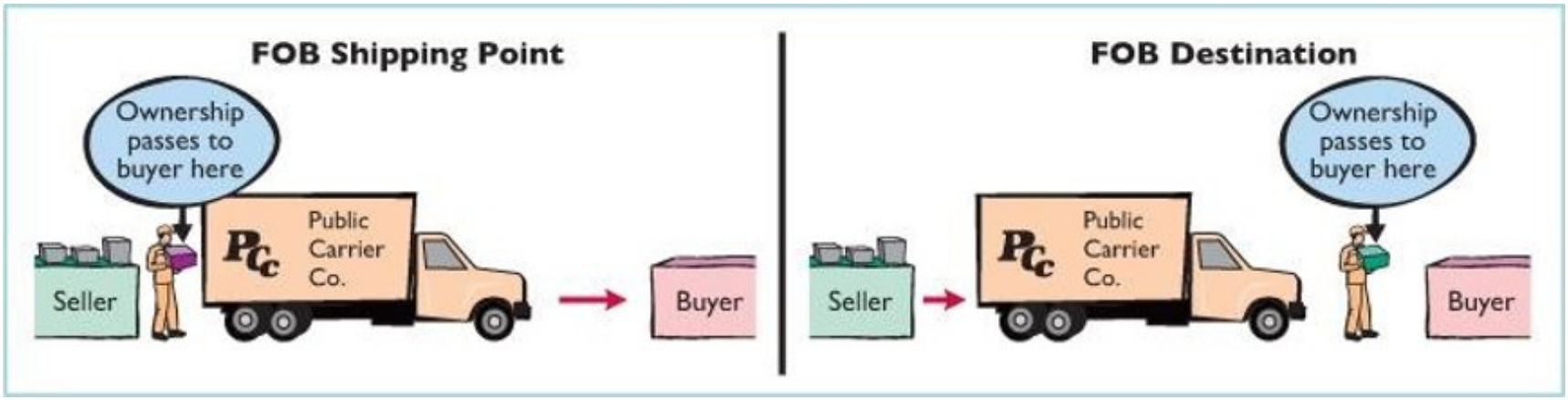
FOB shipping terms

FOB shipping point

- Ownership transfers to the buyer when goods leave the **seller's location**.
- The **buyer** is responsible for shipping costs.

FOB destination

- Ownership transfers to the buyer when goods arrive at the **buyer's location**.
- The **seller** is responsible for shipping costs.



Example

EX 1. Walmart purchased $10,500 of bikes with **FOB destination**. Walmart doesn't pay the transportation cost.

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Inventory (+A)	200	
Cash (-A)		200

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Inventory System

1. **Periodic inventory system**: Inventory is physically counted only at the end of reporting period.[2]

[2] This system seems easy to use, but journal entries are more complex. We do not cover journal entries for this system in this course.

Inventory System

1. **Periodic inventory system**: Inventory is physically counted only at the end of reporting period.[2]
2. **Perpetual inventory system**: Inventory is updated perpetually (i.e., every time inventory is bought, sold, or returned).
   → More accurate and modern when automized inventory tracking is available.

[2] This system seems easy to use, but journal entries are more complex. We do not cover journal entries for this system in this course.

Periodic Inventory System

Inventory is updated **only at the end of reporting period**.

- **Beg. Inventory (BI)** counted at the end of the prior period.
- **Purchases** counted during the period.
- **Ending Inventory (EI)** counted at the end of the period.
- **CGS**: **inferred** from the inventory equation:
  $\rightarrow$ **CGS** = **BI** + **Purchases** - **EI**.

Example

EX 1. Our company counts inventory at the end of each month. The following information is available:

- Beginning Inventory (BI): \$100
- Purchases: \$200
- Ending Inventory (EI): \$150

What is the Cost of Goods Sold (CGS) for the month?

Example

EX 1. Our company counts inventory at the end of each month. The following information is available:

- Beginning Inventory (BI): \$100
- Purchases: \$200
- Ending Inventory (EI): \$150

What is the Cost of Goods Sold (CGS) for the month?

- CGS: **\$150**

Perpetual Inventory System

Inventory is updated perpetually (i.e., every time inventory is bought, sold, or returned).

EX 1. BI= \$100. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

Date	Purchases	Sales	Inventory Balance
Jan 1	\$300		_____
Jan 10	\$100		_____
Jan 20		\$200	_____

- EI:
- CGS:

Perpetual Inventory System

Inventory is updated perpetually (i.e., every time inventory is bought, sold, or returned).

- Every moment, we know **CGS** and **Inventory**.

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Jan 20		\$200	**\$300**

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Date	Purchases	Sales	Inventory Balance
Jan 1	\$300		\$400
Jan 10	\$100		\$500
Jan 20		\$200	**\$300**

- EI: **\$300**
- CGS:

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Inventory is updated perpetually (i.e., every time inventory is bought, sold, or returned).

- Every moment, we know **CGS** and **Inventory**.
- Inventory equation isn't needed to calculate **CGS**.

EX 1. BI= \$100. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

Date	Purchases	Sales	Inventory Balance
Jan 1	\$300		\$400
Jan 10	\$100		\$500
Jan 20		\$200	**\$300**

- EI: **\$300**
- CGS: **\$200**

Perpetual Inventory System

EX 2. BI= \$500. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

Date	Purchases	Sales	Inventory Balance
Feb 1	\$200		
Feb 5		\$100	
Feb 10	\$100		
Feb 15		\$200	
Feb 28		\$200	

- EI: ____
- CGS: ____

Once again, under Perpeutal Inventory System,

- Inventory and CGS are updated every time inventory is bought and sold.
- Inventory equation is **not needed** to calculate the CGS.

Perpetual Inventory System

EX 2. BI= \$500. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

Date	Purchases	Sales	Inventory Balance
Feb 1	\$200		\$700
Feb 5		\$100	
Feb 10	\$100		
Feb 15		\$200	
Feb 28		\$200	

- EI: ____
- CGS: ____

Once again, under Perpeutal Inventory System,

- Inventory and CGS are updated every time inventory is bought and sold.
- Inventory equation is **not needed** to calculate the CGS.

EX 2. BI= \$500. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

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Feb 5		\$100	\$600
Feb 10	\$100		
Feb 15		\$200	
Feb 28		\$200	

- EI: ____
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Feb 5		\$100	\$600
Feb 10	\$100		\$700
Feb 15		\$200	
Feb 28		\$200	

- EI: ____
- CGS: ____

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Feb 1	\$200		\$700
Feb 5		\$100	\$600
Feb 10	\$100		\$700
Feb 15		\$200	\$500
Feb 28		\$200	

- EI: ____
- CGS: ____

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Perpetual Inventory System

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Feb 1	\$200		\$700
Feb 5		\$100	\$600
Feb 10	\$100		\$700
Feb 15		\$200	\$500
Feb 28		\$200	\$300

- EI: ____
- CGS: ____

Once again, under Perpeutal Inventory System,

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Perpetual Inventory System

EX 2. BI= \$500. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

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Feb 1	\$200		\$700
Feb 5		\$100	\$600
Feb 10	\$100		\$700
Feb 15		\$200	\$500
Feb 28		\$200	\$300

- EI: **300**
- CGS: ___

Once again, under Perpeutal Inventory System,

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- Inventory equation is **not needed** to calculate the CGS.

Perpetual Inventory System

EX 2. BI= \$500. Consider the following transactions. What is the inventory balance at the end of each month? and what is the CGS? (\$ amounts are **acquisition costs.**)

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Feb 1	\$200		\$700
Feb 5		\$100	\$600
Feb 10	\$100		\$700
Feb 15		\$200	\$500
Feb 28		\$200	\$300

- EI: **300**
- CGS: **500**

Once again, under Perpeutal Inventory System,

- Inventory and CGS are updated every time inventory is bought and sold.
- Inventory equation is **not needed** to calculate the CGS.

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

- Before counting, we thought the inventory was \$300.

CGS (+E, -SE)		
Inventory (-A)		

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

- Before counting, we thought the inventory was \$300.
- After counting, we found that the inventory is only \$250.

CGS (+E, -SE)	___	
Inventory (-A)		___

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

- Before counting, we thought the inventory was \$300.
- After counting, we found that the inventory is only \$250.
- Something is wrong with the inventory.

CGS (+E, -SE)	___	
Inventory (-A)		___

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

- Before counting, we thought the inventory was \$300.
- After counting, we found that the inventory is only \$250.
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- This is called **Inventory Shrinkage**.

CGS (+E, -SE)	___	
Inventory (-A)		___

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

- Before counting, we thought the inventory was \$300.
- After counting, we found that the inventory is only \$250.
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- This is called **Inventory Shrinkage**.
- Examples are damage, theft, vandalism, natural disaster, expiration, obsolete, etc.

CGS (+E, -SE)		
Inventory (-A)		

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

- Before counting, we thought the inventory was \$300.
- After counting, we found that the inventory is only \$250.
- Something is wrong with the inventory.
- This is called **Inventory Shrinkage**.
- Examples are damage, theft, vandalism, natural disaster, expiration, obsolete, etc.
- We need to record the inventory shrinkage as an expense.

CGS (+E, -SE)		
Inventory (-A)		

Perpetual Inventory System and Inventory Shrinkage

From the previous example, what if EI is \$250 instead of \$300 when physically counted?

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- Something is wrong with the inventory.
- This is called **Inventory Shrinkage**.
- Examples are damage, theft, vandalism, natural disaster, expiration, obsolete, etc.
- We need to record the inventory shrinkage as an expense.

CGS (+E, -SE)	**50**	
Inventory (-A)		**50**

Inventory Shrinkage

Inventory Shrinkage

- The difference between the inventory balance in the books and the inventory balance physically counted, resulting from losses such as damage, theft, etc.
- Inventory Shrinkage is recorded as an expense.

EX 1. Journal entries if $1,000 from inventory equation, but only $900 physically counted.

CGS (+E, -SE)	___	
Inventory (-A)		___

Inventory Shrinkage

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EX 1. Journal entries if $1,000 from inventory equation, but only $900 physically counted.

CGS (+E, -SE)	100	
Inventory (-A)		100

Inventory Shrinkage Example

EX 2. At the end of the accounting period, a company has the following information:

- Beginning Inventory: $5,000
- Purchases during the period: $2,000
- Cost of Goods Sold: $4,500
- A physical count of inventory reveals only $2,300 of inventory on hand.

Required:

- Calculate the amount of inventory shrinkage the company should record.
- Record the journal entry to record the inventory shrinkage.

Inventory Shrinkage Example

Solution:

Description	**Amount ($)**
Beginning Inventory	5,000
Purchases during the period	2,000
Cost of Goods Sold	(4,500)
Ending Inventory (per books) [1]	_____
Physical Count of Inventory [2]	_____
Inventory Shrinkage ([1] - [2])	____

Journal Entry to Record Inventory Shrinkage:

CGS (+E, -SE)	____	
Inventory (-A)		____

Inventory Shrinkage Example

Solution:

Description	Amount ($)
Beginning Inventory	5,000
Purchases during the period	2,000
Cost of Goods Sold	(4,500)
Ending Inventory (per books) [1]	**2,500**
Physical Count of Inventory [2]	
Inventory Shrinkage ([1] - [2])	

Journal Entry to Record Inventory Shrinkage:

CGS (+E, -SE)		
Inventory (-A)		

Inventory Shrinkage Example

Solution:

Description	Amount ($)
Beginning Inventory	5,000
Purchases during the period	2,000
Cost of Goods Sold	(4,500)
Ending Inventory (per books) [1]	2,500
Physical Count of Inventory [2]	2,300
Inventory Shrinkage ([1] - [2])	___

Journal Entry to Record Inventory Shrinkage:

CGS (+E, -SE)	___	
Inventory (-A)		___

Inventory Shrinkage Example

Solution:

Description	Amount ($)
Beginning Inventory	5,000
Purchases during the period	2,000
Cost of Goods Sold	(4,500)
Ending Inventory (per books) [1]	2,500
Physical Count of Inventory [2]	2,300
Inventory Shrinkage ([1] - [2])	200

Journal Entry to Record Inventory Shrinkage:

CGS (+E, -SE) ____
  Inventory (-A) ____

Inventory Shrinkage Example

Solution:

Description	Amount ($)
Beginning Inventory	5,000
Purchases during the period	2,000
Cost of Goods Sold	(4,500)
Ending Inventory (per books) [1]	2,500
Physical Count of Inventory [2]	2,300
Inventory Shrinkage ([1] - [2])	200

Journal Entry to Record Inventory Shrinkage:

CGS (+E, -SE)	200	
Inventory (-A)		200

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Note: We use the Perpetual Inventory System in Ch6.

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- is used to demonstrate the accounting for inventory purchase and sale transactions.
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- maintains the **inventory** and **CGS** on a perpetual basis.
- enables **inventory** and **CGS** to be updated every time inventory is bought or sold.
- is widely used in practice.

Note: The **periodic inventory system** requires the use of separate temporary accounts for PURCHASES, TRANSPORTATION, etc. This goes beyond the scope of this course.

Journal entries for Inventory Purchase Transactions

1. Walmart receives $10,500 of bikes purchased on account.

2. When buying the bikes, Walmart must pay the transportation cost of $200 to a trucker (Cost Principle).

3. Walmart returned some of the bikes to the supplier and received a $500 reduction in the balance owed.

Journal entries for Inventory Purchase Transactions

1. Walmart receives $10,500 of bikes purchased on account.

Inventory (+A)	10,500	
Accounts Payable (+L)		10,500

2. When buying the bikes, Walmart must pay the transportation cost of $200 to a trucker (Cost Principle).

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Journal entries for Inventory Purchase Transactions

1. Walmart receives $10,500 of bikes purchased on account.

Inventory (+A)	10,500	
Accounts Payable (+L)		10,500

2. When buying the bikes, Walmart must pay the transportation cost of $200 to a trucker (Cost Principle).

Inventory (+A)	200	
Cash (-A)		200

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Journal entries for Inventory Purchase Transactions

1. Walmart receives $10,500 of bikes purchased on account.

Inventory (+A)	10,500	
Accounts Payable (+L)		10,500

2. When buying the bikes, Walmart must pay the transportation cost of $200 to a trucker (Cost Principle).

Inventory (+A)	200	
Cash (-A)		200

3. Walmart returned some of the bikes to the supplier and received a $500 reduction in the balance owed.

Accounts Payable (-L)	500	
Inventory (-A)		500

Journal entries for Inventory Selling Transactions

4. Walmart sells four mountain bikes at a selling price of $200 per bike, for a total of $800 cash. The bikes had previously been recorded in Walmart's Inventory at a cost of $175 per bike, for a total cost of $700.

Cash (+A)	800	
Revenues (+R, +SE)		800

After the above transactions, by how much have the following accounts changed?

Account	Balance
Cash	
Accounts Payable	
Inventory	
Revenues	
Cost of Goods Sold	
Gross Profit	

Journal entries for Inventory Selling Transactions

4. Walmart sells four mountain bikes at a selling price of $200 per bike, for a total of $800 cash. The bikes had previously been recorded in Walmart's Inventory at a cost of $175 per bike, for a total cost of $700.

Cash (+A)	800	
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Cost of Goods Sold (+E, -SE)	700	
Inventory (-A)		700

After the above transactions, by how much have the following accounts changed?

Account	Balance
Cash	
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Revenues (+R, +SE)		800

Cost of Goods Sold (+E, -SE)	700	
Inventory (-A)		700

After the above transactions, by how much have the following accounts changed?

Account	Balance
Cash	600
Accounts Payable	
Inventory	
Revenues	
Cost of Goods Sold	
Gross Profit	

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After the above transactions, by how much have the following accounts changed?

Account	Balance
Cash	600
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Cost of Goods Sold (+E, -SE)	700	
Inventory (-A)		700

After the above transactions, by how much have the following accounts changed?

Account	Balance
Cash	600
Accounts Payable	10,000
Inventory	9,500
Revenues	
Cost of Goods Sold	
Gross Profit	

Journal entries for Inventory Selling Transactions

4. Walmart sells four mountain bikes at a selling price of $200 per bike, for a total of $800 cash. The bikes had previously been recorded in Walmart's Inventory at a cost of $175 per bike, for a total cost of $700.

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Revenues (+R, +SE)		800

Cost of Goods Sold (+E, -SE)	700	
Inventory (-A)		700

After the above transactions, by how much have the following accounts changed?

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Cash	600
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Cost of Goods Sold	
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Cash (+A)	800	
Revenues (+R, +SE)		800

Cost of Goods Sold (+E, -SE)	700	
Inventory (-A)		700

After the above transactions, by how much have the following accounts changed?

Account	Balance
Cash	600
Accounts Payable	10,000
Inventory	9,500
Revenues	800
Cost of Goods Sold	700
Gross Profit	100

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Single-Step Income Statement

ABC, Inc.
Income Statement
For the Years Ended Dec 31
(amounts in millions)

Account	**2027**	**2026**
Revenues:		
Net Sales	12,000	11,000
Expenses:		
Cost of Goods Sold	7,800	7,200
SG&A Expenses[3]	2,000	1,900
Other Expenses (Net)[4]	100	50
Income Tax Expense	630	555
Net Income	1,470	1,295

[3] SG&A stands for Selling, General, and Administrative Expenses, including a variety of operating expenses such as salaries and wages, utilities, and rent.

[4] Other Expenses (Net) includes miscellaneous expenses and revenues that do not involve the core business operations (e.g., interest expense or interest revenue). This goes beyond the scope of this course.

Multi-Step Income Statements

ABC, Inc.
Income Statement
For the Years Ended Dec 31
(amounts in millions)

Account	**2027**	**2026**
Net Sales	12,000	11,000
Cost of Goods Sold	7,800	7,200
Gross Profit	4,200	3,800
SG&A Expenses[5]	2,000	1,900
Income from Operations	2,200	1,900
Other Expenses (Net)[6]	100	50
Income before Income Tax	2,100	1,850
Income Tax Expense	630	555
Net Income	1,470	1,295

[5] SG&A stands for Selling, General, and Administrative Expenses, including a variety of operating expenses such as salaries and wages, utilities, and rent.

[6] Other Expenses (Net) includes miscellaneous expenses and revenues that do not involve the core business operations (e.g., interest expense or interest revenue). This goes beyond the scope of this course.

Net Sales

- Some customers (e.g., 3%) return the products they purchased.
- Firms record the estimated returns as **Sales Returns and Allowances**.[7]
- Firm's **Net Sales** is the total sales revenue minus the sales returns and allowances.
- Income Statement usually starts with **Net Sales**, but it depends on the firm's policy.

ABC, Inc.
Net Sales Calculation
For the Years Ended Dec 31
(amounts in millions)

Account	**2027**	**2026**
Sales Revenue	12,300	11,200
Less: Sales Returns & Allowances	300	200
Net Sales	**12,000**	**11,000**
Cost of Goods Sold	7,800	7,200
Gross Profit	4,200	3,800
...	...	...
...	...	...
Net Income	1,470	1,295

[7] **Sales Returns and Allowances** is a contra account that is used to record the estimated returns of sales. This goes beyond the scope of this course. We do not cover Sales Returns and Allowances in detail and the related journal entries.

Gross Profit Ratio

Gross Profit

- A profitability measure that shows how much money is left over from revenues after accounting for the cost of goods sold.
- Calculated as: Net Sales – Cost of Goods Sold

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Gross Profit Ratio (or Gross Profit Margin)

- A profitability ratio that measures how much **gross profit** is generated as a percentage of net sales.
- Calculated as: $\frac{\text{Gross Profit}}{\text{Net Sales}}$

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- A profitability measure that shows how much money is left over from revenues after accounting for the cost of goods sold.
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- A profitability ratio that measures how much **gross profit** is generated as a percentage of net sales.
- Calculated as: $\frac{\text{Gross Profit}}{\text{Net Sales}}$

- **2027:** $\frac{4{,}200}{12{,}000} = 0.35$ or 35%
- **2026:** $\frac{3{,}800}{11{,}000} \approx 0.345$ or 34.5%
- **Interpretation:** For every \$1 of sales, about ___ cents is gross profit in 2027.

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- **Interpretation:** For every \$1 of sales, about **35** cents is gross profit in 2027.

Net Profit Ratio

Net Profit

- A profitability measure that shows how much money is left over from revenues after accounting for all expenses.
- Calculated as: Net Sales – All Expenses

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Net Profit Ratio (or Net Profit Margin)

- A profitability ratio that measures how much **net income** is generated as a percentage of net sales.
- Calculated as: $\frac{\text{Net Income}}{\text{Net Revenues}}$

- **2027:** $\frac{1{,}470}{12{,}000} = 0.1225$ or 12.25%
- **2026:** $\frac{1{,}295}{11{,}000} \approx 0.1177$ or 11.77%
- **Interpretation:** For every \$1 of sales, about _____ cents is net profit in 2027.

Net Profit Ratio

Net Profit

- A profitability measure that shows how much money is left over from revenues after accounting for all expenses.
- Calculated as: Net Sales – All Expenses

Net Profit Ratio (or Net Profit Margin)

- A profitability ratio that measures how much **net income** is generated as a percentage of net sales.
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- **2027:** $\frac{1{,}470}{12{,}000} = 0.1225$ or 12.25%
- **2026:** $\frac{1{,}295}{11{,}000} \approx 0.1177$ or 11.77%
- **Interpretation:** For every \$1 of sales, about **12.25** cents is net profit in 2027.