Merchandise Inventory

Planning and Recording a Merchandise Inventory Adjustment

In addition to supplies and prepaid insurance, merchandising businesses need to adjust the merchandise inventory account. Planning the adjustment is similar to the adjustment for supplies. However, the adjusting entry includes a new account.

The amount of goods on hand for sale to customers is called merchandise inventory. The general ledger account in which merchandise inventory is recorded is titled "merchandise inventory". This account is an asset account with a normal debit balance.

During a fiscal period, the amount of merchandise on hand increases each time merchandise is purchased. However, all purchases are recorded in the purchases account. The amount of merchandise on hand decreases each time merchandise is sold. However, all sales are recorded in the sales account. This procedure makes it easier to determine the total purchases and sales during a fiscal period. The merchandise inventory account, therefore, must be adjusted to reflect the changes resulting from purchases and sales during a fiscal period.

The two accounts used to adjust the merchandise inventory are Merchandise Inventory and Income Summary. Why Income Summary? When an account that requires adjusting does not have a related expense account, the temporary account "income summary" is used. There is no expense account related to merchandise inventory, so we must use income summary to make the adjusting entry.

Example

On January 1, 2024, Hobby Shack's merchandise inventory account has a debit balance of $140,480.00. This merchandise inventory account, however, is not up-to-date. The actual count of merchandise on January 31 is valued at $124,640.00. Therefore, the merchandise inventory account balance must be adjusted to show the current value of merchandise on hand.

Four questions are asked in analyzing the adjustment for merchandise inventory:
1. What is the balance of Merchandise Inventory? $140,480.00
2. What should the balance be for this account? $124,640.00
3. What must be done to correct the account balance? Decrease $15,840.00
4. What adjustment is made? Debit Income Summary $15,840.00 and credit Merchandise Inventory, $15,840.00

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED		Adjustments		ADJUSTED	
	Debit	Credit	Debit	Credit	Debit	Credit
Merchandise Inventory	140 480 00			15 840 00	124 640 00	
Income Summary			15 840 00		15 840 00	

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2024 Date		Account Title	Doc. No.	Post. Ref.	Debit	Credit
January	*31*	*Income Summary*			15 840 00	
		Merchandise Inventory				15 840 00

Income summary is debited and merchandise inventory is credited for $15,840.00. The beginning debit balance of merchandise inventory, $140,480.00 minus the adjusting credit amount, $15,840.00, equals the ending debit balance of merchandise inventory, $124,640.00.

If the amount of merchandise inventory on hand at the end of the fiscal period is greater than the beginning balance, opposite entries would be made (debit merchandise inventory and credit income summary).

Practice Problem 1: Coastal Aquatics

Coastal Aquatics has a merchandise inventory balance on December 1, 2023 of $248,752.25. From a physical count of merchandise inventory, the December 31 balance is determined to be $234,904.20. Prepare the adjusting entry in the trial balance and journalize the transaction in the general journal.

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED		Adjustments		ADJUSTED	
	Debit	Credit	Debit	Credit	Debit	Credit
Merchandise Inventory						
Income Summary						

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Date		Account Title	Doc. No.	Post. Ref.	Debit	Credit

Practice Problem 2: Sonoma Treasures

Sonoma Treasures has a merchandise inventory balance on March 1, 2024 of $261,089.97. From a physical count of merchandise inventory, the March 31 balance is determined to be $264,248.84. Prepare the adjusting entry in the trial balance and journalize the transaction in the general journal.

TRIAL BALANCE

ACCOUNT TITLE	UNADJUSTED		Adjustments		ADJUSTED	
	Debit	Credit	Debit	Credit	Debit	Credit
Merchandise Inventory						
Income Summary						

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Date		Account Title	Doc. No.	Post. Ref.	Debit	Credit

Why Merchandise Inventory Is So Important

Merchandise inventory on hand is typically the largest asset of a merchandising business. Successful businesses must have merchandise available for sale that customers want. A business therefore needs controls that assist managers in maintaining a merchandise inventory of sufficient quantity, variety, and price.

The cost of merchandise inventory is reported on both the balance sheet and the income statement. An accurate cost of merchandise inventory is required to correctly report current assets and retained earnings on the balance sheet. The accuracy of the inventory cost will also assure that gross profit and net income are reported correctly on the income statement.

The Most Efficient Quantity of Inventory

To determine the most efficient quantity of inventory, a business makes frequent analysis of purchases, sales, and inventory records. Many businesses fail because too much or too little merchandise inventory is kept on hand. A business that stocks merchandise that does not satisfy its customers is also likely to fail.

A merchandise inventory that is larger than needed may decrease net income of a business for several reasons:

1. Excess inventory requires that a business spend money for expensive store and warehouse space.
2. Excess inventory uses capital that could be invested in other assets to earn a profit for the business.
3. Excess inventory requires that a business spend money for expenses, such as taxes and insurance premiums, which increase with the cost of merchandise inventory.
4. Excess inventory may become obsolete and unsalable.

Merchandise inventory that is smaller than needed may also decrease the net income of a business for several reasons:

1. Sales may be lost to competitors if items wanted by customers are not on hand.
2. Sales may be lost to competitors if there is an insufficient variety of merchandise to satisfy customers.
3. When a business frequently orders small quantities of an item, the price paid is often more per unit than when merchandise is ordered in large quantities.