

GLOBAL
EDITION



Horngren's Financial & Managerial Accounting

The Financial Chapters

SEVENTH EDITION

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HORNGREN'S
**Financial & Managerial
Accounting**
THE FINANCIAL CHAPTERS

SEVENTH EDITION
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Exhibit F:5-8 | Multi-Step Income Statement

SMART TOUCH LEARNING	
Income Statement	
Year Ended December 31, 2025	
Gross Profit	Net Sales Revenue \$ 920,000
	Cost of Goods Sold 540,000
	Gross Profit 380,000
Operating Income	Operating Expenses:
	Selling Expenses:
	Salaries Expense \$ 44,160
	Rent Expense 38,280
	Advertising Expense 11,800
	Depreciation Expense—Building 1,500
	Delivery Expense 7,800
	Total Selling Expenses 103,540
	Administrative Expenses:
	Utilities Expense 55,500
	Salaries Expense 29,440
	Insurance Expense 31,900
	Rent Expense 25,520
	Depreciation Expense—Furniture 1,800
	Supplies Expense 2,900
	Total Administrative Expenses 147,060
	Total Operating Expenses 250,600
	Operating Income 129,400
Other Income and (Expenses) and Income Before Income Tax Expense	Other Income and (Expenses):
	Sales Discounts Forfeited 2,000
	Interest Expense (11,000)
	Total Other Income and (Expenses) (9,000)
Income Tax Expense and Net Income	Income Before Income Tax Expense 120,400
	Income Tax Expense 18,980
	Net Income \$ 101,420

The income statement begins by calculating gross profit. Gross profit is the markup on the merchandise inventory and is calculated as net sales revenue minus cost of goods sold. Net sales revenue is sales revenue less discounts and estimated returns and allowances. Gross profit, along with net income, is a measure of a business's success. A sufficiently high gross profit is vital to a merchandiser. Next, the operating expenses, those expenses other than cost of goods sold that are related to the day-to-day operations of the business, are listed.

Both merchandisers and service companies report operating expenses in two categories:

- **Selling expenses** are operating expenses related to marketing and selling the company's goods and services. These include sales salaries, sales commissions, advertising, depreciation on store buildings and equipment, store rent, utilities on store buildings, property taxes on store buildings, and delivery expense.

Selling Expenses

Operating expenses related to marketing and selling the company's goods and services.



Administrative Expenses

Operating expenses incurred that are not related to marketing the company's goods and services.

Operating Income

Measures the results of the entity's major ongoing activities. Gross profit minus operating expenses.

Other Income and Expenses

Revenues or expenses that are outside the normal, day-to-day operations of a business, such as a gain or loss on the sale of plant assets or interest expense.

Income Tax Expense

Expense incurred by a corporation related to federal and state income taxes.

- **Administrative expenses** include operating expenses *not* related to marketing the company's goods and services. These include office expenses, such as the salaries of the executives and office employees; depreciation on office buildings and equipment; rent other than on stores (for example, rent on the administrative office); utilities other than on stores (for example, utilities on the administrative office); and property taxes on the administrative office building.

Gross profit minus operating expenses equals **operating income** (also called *income from operations*). Operating income measures the results of the entity's major ongoing activities (normal operations).

The next section of the income statement is **other income and expenses**. This category reports revenues and expenses that fall outside the business's main, day-to-day, regular operations. Examples include interest revenue, sales discounts forfeited, interest expense, and gains and losses on the sale of plant assets. These examples have nothing to do with the business's "normal" operations but are related to investing or financing activities. As a result, they are classified as "other" items.

Lastly, corporations are required to pay income tax. Therefore, the last section of the income statement is the **income tax expense** section. This section reports the federal and state income taxes that are incurred by the corporation. The calculation of income tax expense is complicated and will be covered in later accounting courses and is only presented here for informational purposes.

Statement of Retained Earnings and the Balance Sheet

A merchandiser's statement of retained earnings looks exactly like that of a service business. The balance sheet will also look the same as for a service business, except merchandisers have additional current asset accounts, Merchandise Inventory and Estimated Returns Inventory. In addition, merchandisers will have an additional current liability account, Refunds Payable, to represent the estimated amount of refunds that are due.

Try It!

11. Capital City Motorcycle's selected accounts as of December 31, 2024, follow:

Selling Expenses	\$ 10,500
Interest Revenue	1,000
Net Sales Revenue	113,000
Cost of Goods Sold	85,000
Administrative Expenses	8,000
Sales Discounts Forfeited	500

Prepare the multi-step income statement for the year ended December 31, 2024.

Check your answers online in MyLab Accounting or at <https://www.pearsonglobaleditions.com/Horngren>.

For more practice, see Short Exercises S-F:5-12 and S-F:5-13. [MyLab Accounting](#)



HOW DO WE USE THE GROSS PROFIT PERCENTAGE TO EVALUATE BUSINESS PERFORMANCE?

Merchandisers use several ratios to evaluate their operations, and among them is the gross profit percentage. The **gross profit percentage** measures the profitability of each sales dollar above the cost of goods sold and is computed as follows:

$$\text{Gross profit percentage} = \text{Gross profit} / \text{Net sales revenue}$$

The gross profit percentage is one of the most carefully watched measures of profitability. It reflects a business's ability to earn a profit on its merchandise inventory. The gross profit earned on merchandise inventory must be high enough to cover the remaining operating expenses and to earn net income. A small increase in the gross profit percentage from last year to this year may signal an important rise in income. Conversely, a small decrease from last year to this year may signal trouble. Gross profit percentages vary among industries, but in general, a high gross profit percentage is desired.

Returning to **Kohl's Corporation** we can now calculate the gross profit percentage. Kohl's Corporation had the following net sales and cost of merchandise sold (cost of goods sold), found on the income statement for the fiscal year ending February 2, 2019. Visit <https://www.pearsonglobaleditions.com/Horngren> for a link to Kohl's Corporation's annual report.

	For year ended Feb. 2, 2019 (in millions)	For year ended February 3, 2018 (in millions)
Net sales	\$ 19,167	\$ 19,036
Cost of merchandise sold	12,199	12,176

Gross profit is calculated as net sales less cost of merchandise sold. To determine the gross profit percentage, the gross profit is then divided by net sales. The gross profit percentage for the year ending February 2, 2019, follows (amounts in millions):

$$\text{Gross profit percentage} = (\$19,167 - \$12,199) / \$19,167 = 0.364 = 36.4\%$$

In comparison, the gross profit percentage for the year ending February 3, 2018, was:

$$\text{Gross profit percentage} = (\$19,036 - \$12,176) / \$19,036 = 0.360 = 36.0\%$$

The gross profit percentage increased slightly from February 3, 2018 to February 2, 2019, signifying that the percentage of gross profit on sales is increasing. However, when compared with the industry average for gross profit percentage, 35%, Kohl's is slightly higher than average. Kohl's should monitor the amount of profit it is earning on its merchandise inventory and take action if the percentage begins to drop.

Learning Objective 6

Use the gross profit percentage to evaluate business performance

Gross Profit Percentage

Measures the profitability of each sales dollar above the cost of goods sold. Gross profit / Net sales revenue.



Try It!

12. Six String Florist’s selected accounts as of December 31, 2024, follow:

Selling Expenses	\$ 8,500
Interest Revenue	2,000
Net Sales Revenue	150,500
Cost of Goods Sold	80,000
Administrative Expenses	10,000

Determine the gross profit percentage for the year ended December 31, 2024.

Check your answer online in MyLab Accounting or at <https://www.pearsonglobaleditions.com/Horngren>.

For more practice, see Short Exercise S-F:5-14. [MyLab Accounting](#)

APPENDIX 5A: Accounting for Multiple Performance Obligations

HOW ARE MULTIPLE PERFORMANCE OBLIGATIONS RECORDED IN A PERPETUAL INVENTORY SYSTEM?

Learning Objective 7

Account for multiple performance obligations using a perpetual inventory system

Under the new revenue recognition standards, companies are required to identify the performance obligations associated with each contract. Remember, a performance obligation is a contractual promise with a customer to transfer a distinct good or service. Some contracts with customers might have multiple performance obligations. For example, assume that Smart Touch Learning often provides its customers with a two-year service contract when it sells its tablets. In this case, there are two distinct performance obligations: the two-year service contract and the tablet.

When contracts involve multiple performance obligations, the company is required to allocate the transaction price to each performance obligation separately. For example, assume on November 1 Smart Touch Learning sells one tablet (cost of \$350) along with a two-year service contract to a customer for \$620. The customer pays cash at the time of the sale. The \$620 sales price must be allocated among each performance obligation. Smart Touch Learning allocates the sales price of \$620 as follows: \$500 for the tablet and \$120 for the two-year service contract.

In recording the transaction, Smart Touch Learning should only recognize revenue when, or as, it satisfies each performance obligation. The \$500 associated with the tablet would be recognized as Sales Revenue because the tablet has been delivered to the customer. The \$120 for the two-year service contract would be recorded as Unearned Revenue because the company has not satisfied the obligation of servicing or fulfilling the service contract. Smart Touch Learning would record the transaction on November 1 as follows:



Date	Accounts and Explanation	Debit	Credit
Nov. 1	Cash	620	
	Sales Revenue		500
	Unearned Revenue		120
	<i>Cash sale including two-year service contract.</i>		
Nov. 1	Cost of Goods Sold	350	
	Merchandise Inventory		350
	<i>Recorded the cost of goods sold.</i>		

$$\begin{array}{l}
 \frac{A \uparrow}{\text{Cash} \uparrow} \left\{ = \left\{ \begin{array}{l} \frac{L \uparrow}{\text{Unearned Revenue} \uparrow} + \frac{E \uparrow}{\text{Sales Revenue} \uparrow} \end{array} \right. \right. \\
 \\
 \frac{A \downarrow}{\text{Merchandise Inventory} \downarrow} \left\{ = \left\{ \begin{array}{l} \frac{L}{\text{Cost of Goods Sold} \uparrow} + \frac{E \downarrow}{\text{Cost of Goods Sold} \uparrow} \end{array} \right. \right.
 \end{array}$$

As Smart Touch Learning satisfies the service contract, the company would recognize the revenue. For example, at December 31, Smart Touch Learning has provided two months of service for the tablet. Smart Touch Learning would record \$10 $(\$120 / 24 \text{ months}) \times 2 \text{ months}$ of Service Revenue when it prepares adjusting entries.

Date	Accounts and Explanation	Debit	Credit
Dec. 31	Unearned Revenue	10	
	Service Revenue $(\$120 / 24 \text{ months}) \times 2 \text{ months}$		10
	<i>Service revenue earned.</i>		

$$\frac{A}{\text{Unearned Revenue} \downarrow} \left\{ = \left\{ \begin{array}{l} \frac{L \downarrow}{\text{Unearned Revenue} \downarrow} + \frac{E \uparrow}{\text{Service Revenue} \uparrow} \end{array} \right. \right.$$

Try It!

13A. Click Computers has the following transactions related to the sale of merchandise inventory.

- | | |
|---------|--|
| Mar. 1 | Sold a computer (cost of \$3,000) for \$8,000 to a customer. The customer paid cash. The sales price included a one-year service contract valued at \$168. |
| Dec. 31 | Recorded the amount of service contract earned. |

Journalize the transactions for Click Computers assuming that the company uses the perpetual inventory system.

Check your answers online in MyLab Accounting or at <https://www.pearsonglobaleditions.com/Horngren>.

For more practice, see Short Exercise S-F:5A-15. [MyLab Accounting](#)

APPENDIX 5B: Accounting for Merchandise Inventory in a Periodic Inventory System

HOW ARE MERCHANDISE INVENTORY TRANSACTIONS RECORDED IN A PERIODIC INVENTORY SYSTEM?

Learning Objective 8

Account for the purchase and sale of merchandise inventory using a periodic inventory system

Some smaller businesses find it too expensive to invest in a perpetual inventory system. These businesses use a periodic inventory system. In a periodic inventory system, businesses must obtain a physical count of inventory to determine quantities on hand.

Purchases of Merchandise Inventory—Periodic Inventory System

All inventory systems use the Merchandise Inventory account. But in a periodic inventory system, purchases, purchase returns and allowances, purchase discounts, and freight in costs are recorded in separate accounts during the year and then the Merchandise Inventory account is updated in the closing process. Let’s account for Smart Touch Learning’s purchase of the tablet computers from Southwest Electronics Direct as shown in Exhibit F:5-3. Remember, Smart Touch Learning purchased \$35,000 of inventory with terms 3/15, n/30.

Under the periodic inventory system, Smart Touch Learning will record the purchase of inventory using an account called Purchases (an expense account). Unlike in a perpetual inventory system, the purchase of inventory is not recorded directly into the Merchandise Inventory account.

A

=

L↑

Accounts Payable↑

+

E↓

Purchases↑

Date	Accounts and Explanation	Debit	Credit
Jun. 3	Purchases	35,000	
	Accounts Payable—Southwest Electronics Direct		35,000
	<i>Purchased inventory on account.</i>		

Purchase Returns and Allowances—Periodic Inventory System

Suppose that, prior to payment, on June 6, Smart Touch Learning returned 20 tablets that cost \$7,000 to Southwest Electronics Direct, the vendor. Smart Touch Learning would record this return as follows:

A

=

L↓

Accounts Payable↓

+

E↑

Purchase Returns and Allowances↑

Date	Accounts and Explanation	Debit	Credit
Jun. 6	Accounts Payable—Southwest Electronics Direct	7,000	
	Purchase Returns and Allowances		7,000
	<i>Returned inventory to seller (vendor).</i>		