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Optional Discount

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Accounting opinion on cash discount takes the two rather extreme views that discount equivalent to interest of 36½ per cent. per annum is a financial gain and that in no case is financial gain realized. As a reasonable and practical compromise there is presented here the view that every cash discount includes a financial gain up to but not exceeding the equivalent of interest of 9.125 per cent. per annum. The ground for this intermediate position is that the use of money being the essence of optional discount payment for that use is inherent in the transaction to the extent of a reasonable interest, and a thing acquired costs the money paid for it plus whatever the earlier giving up of the money costs.

This may be illustrated by re-stating a plain little invoice of "Merchandise $100.00, terms 2–10 net 30" somewhat as follows:

List or basic price	$188.00
Trade discount—40, 10 and 1½%	88.00
Invoice price—the amount required to be paid if payment is made in 30 days	100.00
Trade allowance—a reduction made for payment in 10 days in recognition of the fact that earlier payment decreases the seller's credit risk and collection expense	1.51
Cost of goods	98.49
Cash discount—a reduction made for payment in 10 days in recognition of the fact that money earns interest; a reasonable interest being considered ½ of 1% for 20 days prepayment, equivalent to 9.125% per annum	.49
Discounted price—the amount acceptable if payment is made in 10 days	$98.00

That interest is an actual cost in the transaction is a fact which can not be argued away. In electing to discount, the purchaser not only gives up money but gives up also the right to the use of that money—a right which is of definite money value to him. If this is sound it warrants taking the highly desirable position that sufficiency or lack of capital does not affect the price of goods; that goods cost the same to all purchasers enjoying like quotations and that discounting or not discounting does not affect the cost of goods.

In attempting to arrive at that uniform cost it seems reasonable to regard the invoice price as a purely nominal figure and the discounted price as the real base of the true cost—this for two reasons; it accords with the view of the seller who initiates the discount, and, while there is no arbitrary compulsion, the purchaser is strongly moved to take and the seller strongly moved to give the discount.

The purchaser's incentive is, of course, to save money—usually in an amount much greater than reasonable interest. The seller's incentive is first the use of money and second to benefit in other ways, such as reduced credit risk, lessened collection expense and perhaps increased volume and turnover—all valuable considerations.

In the following optional discounts commonly quoted in various trades the accountant's problem under this intermediate plan is to determine what portion is for the use of money and what portion for other benefits or considerations.

Per cent	For prepayment of	Approximate equivalent annual rate
From ½ to 10	20 days	9 to 203%
From 1 to 5	30 days	12 to 64%
From 1 to 6	50 days	7 to 47%
2	60 days	12%
2	80 days	9%
From 2 to 7	110 days	7 to 25%

The exact and accurate division probably would vary in all cases, but those variations being impossible of ascertainment the practicable course is to treat all alike.

Consistent and uniform treatment in accounts waits only general agreement upon a fixed theoretical dividing line. To find that line we must have a standard measure. It seems reasonable to base that normal measure upon the commonly quoted discount bearing the closest resemblance to a composite of commercial interest, legal interest and fair return on capital. Terms of ½ of 1 per cent. 10 days net 30 days, which seems nearest to meeting that requirement, would give a 9.125 per cent. annual rate as the measure of true cash discount. For example:

Terms	½% 10 net 30	2% 10 net 30	4% 30 net 60
Invoice price	$100.00	$100.00	$100.00
Trade allowance	......	1.51	3.28
Cost of goods	100.00	98.49	96.72

Cash discount:			
.09125 per annum			
.00025 per diem			
20 days at .00025 = .005			
$99.50 at .005...........	$ .50		
$98.00 at .005...........		$ .49	
30 days at .00025 = .0075..			
$96.00 at .0075..........			$ .72
Discounted price...........	$99.50	$98.00	$96.00

The bookkeeping is simple:

On books of	Ledger account	Dr.	Cr.	
Seller:	Accounts receivable..	$100.00		Original entries
	Sales		$100.00	
Purchaser:	Cost of goods.......	98.49		
	Trade allowances....	1.51		
	Accounts payable....		100.00	
Purchaser:	Accounts payable...	2.00		Further entries if discount option exercised
	Trade allowances....		1.51	
	Cash discount......		.49	
Seller:	Trade allowances....	1.51		
	Cash discount......	.49		
	Accounts receivable .		2.00	

Where purchases are permanently capitalized and discount not taken, a further entry credits "trade allowances" and charges the fixed asset. The seller in effect says "my price is $98.49. If paid in 10 days I will return to you 49 cents as interest. If paid in 30 days I will add $1.51 for my increased credit risk and collection expense, and that you will have to set down to your cost of lack of capital."

There is much to be said in favor of this intermediate view. Supply, store and stock records would have a definite and unchangeable cost figure to deal with, unaffected by the taking or neglecting of discount and eliminating voucher corrections.

It solves the question of discount in inventories.

It would show (except for capitalized items) neglected trade allowances. That other part of the discount which is really for cash can hardly be classed as neglected as it is offset in the earning value of money withheld.

It would tend to settle discount controversies in cost-plus cases, free departmental results of any capital effect and furnish a consistent base for commissions or bonuses which hinge upon gross or operating profits.

It cares for complex terms. Under terms of 5 per cent. cash, 2 per cent. 30 days, net 3 months a $100 invoice would be entered as cost of goods $97.17 and trade allowances $2.83; if paid immediately cash discount would be credited $2.17 and trade allowances credited $2.83; if paid in 30 days cash discount would be credited $1.49 and trade allowances credited $.51.

It removes the time element from discount rates. Translated into an annual rate 2 per cent. for 20 days prepayment is four times 2 per cent. for 80 days prepayment.

It comes nearer to placing discount entries in the year to which they relate.

It places selling and buying on the same footing. The business which, treating all discounts of 2 per cent. and under as financial gain, allows ½ of 1 per cent. on its sales and receives 2 per cent. on its purchases, reports a net financial gain of 1½ per cent., whereas as a matter of fact the net financial gain on any adequate interest basis is nothing.

It is in line with legal decisions; which hold that discounting means to take interest in advance and that in ordinary commercial documents discount means rebate of interest.

It conforms to the federal income-tax requirement that strictly cash discount must approximate a fair interest rate.

It closely approximates a present-worth calculation.

And finally, if the reader will turn back to the third paragraph he will see that it is based upon the same two principles which underlie the conflicting views referred to in the opening paragraph.