Journal of Accountancy

Volume 25 | Issue 1 Article 6

1-1918

Cash Discounts

J. H. Schackmann

Cash Discounts

By J. H. Schackmann

In none of the works on accounting which have come under the writer's observation has he seen what in his opinion is a logical, consistent and correct handling of the subject of cash discounts when judged by some of the most fundamental principles of accounting theory and common-sense.

Common-sense surely affirms that a reduction of the cost of anything cannot in itself ever be a profit. Correct accounting theory lays down the law that each accounting period must be charged with only its proper proportion of expense and credited with only its proper proportion of income. It also lays down the law that, when highly desirable or very convenient, assets and liabilities may be booked at a figure higher than their real worth, provided the principle of valuation is reasonable and that proper offsetting valuation accounts are set up so as to bring their net worth to a figure as nearly correct as possible.

Many writers who explicitly set forth these principles do not handle cash discount in accordance with them. Judging from what they say, it appears that many accountants take no cognizance on the books of account of discounts offered or discounts lost, but only of discounts taken. It appears, too, that these accountants take the whole amount of cash discounts received during a period and throw it into the profit and loss account for that period. At this point, however, there is a difference of opinion whether it is correct to handle it as other income or as a reduction of the cost of the goods sold during the period.

Now, cash discount taken is neither other income nor a reduction of the invoice cost of goods sold during the period. It is merely a reduction of the amount of discount available at the time it is taken. It is difficult to see why so many writers on accounting matters regard it as anything else. To consider discount taken in either of the two above-mentioned ways is contrary to accounting principles, and to handle it thus will result in erroneous balance-sheets and profit and loss statements.

The correct view of cash discounts offered is that it is a real reduction of the invoice cost of the thing purchased—an offset, in fact, quite regardless of whether it is taken or lost. If it is lost it is a real loss—a loss that is the cost of taking the longer time before making settlement. If payment is made before the expiration of the discount period and the discount is taken, the cash payment does not discharge a real liability greater than the payment for the simple reason that the face value of the invoice was not owed, and would not have been owed until the discount period had expired, regardless of at what amount the liability was booked. This is the only view of cash discounts that does not contain within itself the germs of inconsistency and that does not work out in conflict with correct accounting principles.

That the latter view is correct and the former wrong will perhaps be clearer if each is applied to the same set of hypothetical cases. Let the following be taken:

Case 1

John Doe begins business January 1 with $100,000 cash. January 25 he buys $100,000 worth of goods at 2 per cent. off if paid in 10 days. January 31 he pays the bill and takes the discount. No other transaction for January or February.

Case 2

This case is the same as case 1 except that the bill is paid on February 1.

Case 3

This case is the same as case 1 except that payment is not made until February after the discount period has expired.

Case 4

This case is the same as case 1 except that during January John Doe sold 45 per cent. of the goods at a profit of 20 per cent. above invoice price, and during February he sold the remaining 55 per cent. on the same basis.

Handling cash discounts according to the first view the following are the results:

Case 1: A profit of $2,000 in January; none in February.

Case 2: A profit of $2,000 in February; none in January.

Case 3: No profit in either month.

Case 4: A profit of $11,000 in January; and a profit of $11,000 in February.

These results are obviously incorrect and absurd. In cases 1 and 2, profits were shown as made, although there were no sales in either month. Case 3 shows neither a loss nor a gain, although the goods on hand could be duplicated for only $98,000. Case 4 shows an equal amount of profit for each month, although the rate of cost and the rate of profit were the same in each, and the sales of the latter exceeded the sales of the former by 22.22 per cent. Could there be a plainer demonstration that this manner of handling cash discount is altogether wrong?

Correct Method of Handling Cash Discounts

Because of the desirability and great convenience of booking purchases and the corresponding accounts payable at the invoice price, they should be so booked. Account must be kept of the amount of discount offered, and this must be set up on the books as follows:

Discounts available on accounts payable dr. to
Discount on invoice price of purchases

The first is a valuation account of accounts payable; the second, of merchandise. The first is written off the books by crediting to it the amount of cash discount taken—the corresponding debit being to accounts payable—and the amount of discounts lost—the corresponding debit being to the profit and loss account. The amount unexpired at the end of an accounting period is carried forward as the opening balance of the following period. The second is written off by debiting it for a proper proportion and crediting cost of goods sold during the period, the latter being calculated on a basis of invoice cost. In arriving at the proper proportion find the percentage that the cost of goods sold bears to the total of the opening inventory and the purchases for the period, and take that percentage of the balance of the discount account.

According to this method cases 1 and 2 would show no profit in either month. Case 3 would show a loss of $2,000 in February, but neither a profit nor a loss in January. Case 4 would show a profit of $9,900 in January and a profit of $12,100 in February, an increase over January of $2,200, or 22.22 per cent., as it should be when the rate of cost and the rate of profit are alike and sales increased 22.22 per cent.

I anticipate two objections: the one that not all discounts on purchases are applicable to what is sold again, in which case it is plainly a question of the proper proportions and the proper accounts to credit when the discount on purchases is written off, but the principle stands; the other is the practical difficulty of applying the principle to concrete cases, but this cannot abrogate the principle, and the difficulty will not be so great as appears at first sight if the books are properly constructed.

I have treated the subject altogether from the viewpoint of cash discounts offered on purchases. But what has been said applies with equal force to cash discounts offered on sales, and, mutatis mutandis, they should be handled in the same way.