Journal of Accountancy

Volume 42 | Issue 3 Article 1

9-1926

Cash Discounts

Erwin J. C. Schmiel

The JOURNAL *of* ACCOUNTANCY

Official Organ of the AMERICAN INSTITUTE OF ACCOUNTANTS

Vol. 42 SEPTEMBER, 1926 No. 3

Cash Discounts

BY ERWIN J. C. SCHMIEL

Accountancy in its present stage of development embraces so many topics of major as well as of minor importance that it has become the practice, virtually born of necessity, to isolate various phases for special study and consideration. Undoubtedly, a searching examination of a particular phase of accounting matters, resulting in accurate and logical conclusions definitely correlated with general accounting principles, should result in giving greater precision to those general principles. However, any theories which may be developed in this manner, but which lead through inferences, though properly drawn from the premises, to conclusions which are found not to conform to basic general principles and which thereby impeach the soundness of the latter, ought to be disregarded at once. On the other hand, it is not impossible that new major theories may be advanced upon such good grounds that a revision or modification of some established principles may become necessary.

While the subject of cash discounts is only a minor topic presenting nothing especially novel and much that is of academic interest only, it nevertheless offers some interesting and speculative aspects. From time to time articles by accountants and economists have appeared in support of the idea that a cash discount is not at all what it is ordinarily conceived to be. Some economists particularly are prone to denounce the traditional views held respecting cash discounts. While it may be true that practical accountancy and economics have very little in common, it does seem desirable (for reasons not pertinent to this discussion) to establish and elaborate upon all common points of contact between economic and accounting theory. Contributions to this end by the economist ought to be welcomed, but it does seem as though on the subject of cash discounts the economist is trying to evolve a theory to fit his conception of their proper practical treatment on the books of account. Apparently it is a case of the tail trying to wag the dog.

The offer of a cash discount by a vendor to a vendee gives the latter an optional plan of settlement which he may decline, accept, or neglect, as expediency may dictate. A typical plan may be stated as "2%/10 days—60 days/net" which, as everyone knows, means that the amount billed is expected to be paid within sixty days, and if it is paid within ten days the vendee may deduct two per cent. from the billed price in settlement. Every theory regarding such two per cent. reduction centers itself wholly around the question, "What does it represent?" The treatment of cash discounts on the books of account is not of great importance in the discussion because any valid theory will suggest its own proper application.

The traditional theory assumes that a cash discount is precisely what the name implies—an allowance for cash. In order to distinguish that conception briefly the term "allowance theory" will be used herein. The alternative theory, diametrically opposed to the foregoing, assumes that the term "price" as it is usually understood is composed of two distinct elements, i. e. the amount which the vendor will accept in full settlement within the discount period, which the proponents of this theory variously term as the real, nominal, or cash price, plus a surcharge which the vendor exacts for non-payment within a specified limited time in order to reimburse himself for additional services rendered by reason of the extended time over which he is compelled to wait for his money. This will be termed the "surcharge theory." In order to avoid any ambiguity, the price as it is usually understood will be termed the "gross price," and the gross price less the amount of the discount, the "net price." The issue, therefore, between the two positions is that one group assumes that the amount of the discount is an allowance, the other, a surcharge.

Opinion seems to be unanimous on one point—that regardless of whether the amount of the discount be an allowance or a surcharge it should be classified in the profit-and-loss statement as a financial management item.

At the outset, it is a fair statement that the cash discount is an identical amount to both the vendor and vendee concerned, to each of whom it must retain the same essential characteristics consistent with the theory that is adopted. Any other view—for instance, an assumption that both sales discounts allowed and purchase discounts neglected are items of expense—is a denial of the individual characteristic of the cash discount itself. To clarify this point, assume that a vendor sells $10,000 worth of merchandise to various vendees, the latter taking a two per cent. discount on one-fourth of their purchases. The vendor under the above assumption would show sales of $10,000 and a debit under financial management expenses of $50 discounts allowed. The combined reports of the vendees would show purchases of $9,800 and a debit under financial management expenses of $150 discounts neglected. In practice similar conditions will be found to obtain frequently, but from a logical standpoint such views merely beg the question, permit ambiguity to replace consistency, and in fact it may be justly contended that such views deny the existence of any principles at all with respect to cash discounts.

With respect to the opposing positions, therefore, if the cash discount is an allowance it must be considered as an expense to the vendor and as an item of income to the vendee when the latter avails himself of the discount privilege. If he declines or neglects the discount privilege the part of the sales contract relating to cash discounts becomes inoperative. But if the amount of the cash discount is a surcharge it takes effect only when the vendee fails to make payment within the discount period, and in that event the amount of the surcharge is an expense to the vendee and an item of income to the vendor.

The controversy seems to center itself around purchase discounts to the complete disregard of sales discounts. However, the relationship between the two is one of such mutual dependence that in any discussion independent theories respecting either must be subordinated to the central idea of a cash discount. The offer of the discount privilege originates solely with the vendor, who determines the rate of discount, or surcharge, and therefore the motives which induce the vendor to make the offer ought to be a prime consideration in determining the nature of the discount. Yet in actual practice this is not always quite true, because very often the only compelling reason for offering cash discounts is imposed upon the vendor from extraneous sources: for instance, by the practice of competitors.

Those who so strenuously oppose the ordinary conception of a cash discount advance what has been termed the surcharge theory. A fair example of their argument, assuming a case of a sale for

$100 less a two per cent. discount for payment within ten days, runs about as follows:

". . . It is ridiculous to assume that any sane business man would sell merchandise reasonably worth one hundred dollars for ninety-eight dollars in cash. . . . "

". . . What really happens, then, when a sale is made for one hundred dollars on the terms mentioned is that the vendor sells merchandise for the nominal value of ninety-eight dollars and charges two dollars to reimburse himself for assuming the additional service. . . ." (By additional service, interest, bookkeeping and credit insurance is understood.)

". . . It is doubtful whether the average business man knows why he allows two per cent. rather than three per cent. or some other rate for cash. . . ."

The first statement above confuses price with value and seems to imply that an absolute value of the merchandise is readily ascertainable. Gross prices are continually subject to the forces of supply and demand without any reference to the cash discount differential. They are also subject to variation by reason of changes in the general price level, which may or may not be accentuated by influences within the scope of any particular industry which may be under examination. In many lines of business there are neither uniform practices with respect to cash discounts nor uniform rates, and it is absurd to assume that any governing market prices are based on so-called cash prices. Finally, the whole statement is based on a false premise, namely, the assumption that the receipt of the net price within the discount period makes the transaction a cash sale. Inasmuch as the discount period varies in different classes of business from ten to thirty days, an acceptance of this theory would involve a somewhat radical change in the usual conception of a cash sale.

The second statement assumes that the discount, or rather the two-dollar surcharge, is a definitely determined charge for services rendered, and the third statement weakens the whole argument with the admission that the average business man does not know why he charges any particular rate. In fact, no relationship exists between this surcharge and any of the services for which it is claimed that the charge is made. Any business man, or any accountant or economist for that matter, would be sorely puzzled as to how to effect any logical reconciliation between the two.

There are many inconsistencies and obstacles in the way of accepting this surcharge theory. For instance, it is difficult to follow the implied consequence that a fixed percentage of a fluctuating gross price will accurately determine the real price and at the same time a consistent amount of surcharge for these additional services, whatever they may be, with the further necessary consequence that the net price and the surcharge amount remain in the same ratio throughout all the fluctuations of gross prices. Following this to a logical conclusion, in the event of increasing gross prices with probably an increased profit for the vendor and no increase in the cost of services rendered for which the surcharge is made and very likely a decrease in the ratio of such costs to gross sales, how can an increased surcharge to the vendor be justified?

Many vendors do not make cash discount offers; nevertheless they do sell on terms of thirty days, sixty days, etc. If we are to accept the surcharge theory, the very reasons, which it is argued impel the vendor who sells for cash if received within the discount period to add a surcharge for extended credit, apply with equal if not more force to the vendor who extends considerable credit but permits no discounts to be taken. So we might be led momentarily to the conclusion, if we accept the validity of the surcharge theory, that every vendor, no matter what his terms may be, calculates his net price first and then adds a surcharge for other services to reimburse himself if payment is not received within the discount period. Of course, this is true neither in practice nor in theory. The rate of discount is a constant factor but the amount of discounts is a constantly fluctuating figure bearing no relationship to the services conceived to be rendered therefor.

The amount of the surcharge has been variously termed as, or compared with, interest, vendor's charge for risk-taking, credit insurance, bookkeeping, etc. Sometimes it is claimed that several of these elements are characteristic of the surcharge.

Those who oppose the idea that the amount of the surcharge resembles interest almost invariably advance as a reason for their opposition the fact that no business man would pay such a high rate for money as they conceive the annualized discount rate to be. For instance, the terms 2%/10 days—net 60 days are said to represent a rate of approximately 72 per cent. per annum, presumably because two per cent. for ten days is about equivalent to

72 per cent. a year. The reasoning is faulty. If the vendee does not pay within ten days, he is then entitled to delay payment for sixty days but loses the discount privilege which is equivalent to saying that he must pay a two per cent. surcharge (exactly .0203+). Therefore, he retains the use of the money for 60 days and the vendor loses it for the same period. This is equivalent to an annual rate of about 12 per cent. On the other hand, if the vendee settles within ten days he loses the use of the money for fifty days and the vendor gains it for at least the same period, making the annual rate equivalent to about 14 per cent.

The fact that any attempt to annualize the discount rate usually results in a rate greater than that ordinarily thought of as a normal or legal interest rate is not the chief objection to assuming discount rates to be interest rates, even though the annualized discount rate were exactly equal to the normal or usual interest rate. Interest is the price or rate per centum per unit of time that is paid for the use of money. So far as discounts are concerned, however, the element of time is indefinite. If terms are quoted as 2%/10 days—net 60 days, the two per cent. discount results in a flat gain if paid within ten days, otherwise it must be paid regardless of whether the vendee settles in 30, 60, or 90 days. Now, if payment is not received in ten days, the assumption that the surcharge at the rate of two per cent. is interest whether for 30, 60, or 90 days does not meet one of the cardinal requirements of the interest concept.

The idea that the amount of the surcharge is a charge for risk-taking or for credit insurance is not very appealing. Why a particular vendee who does not take the discount, but in fact does pay his bills within thirty or sixty days—and this may happen time after time in the case of some particular vendees—should be penalized by an additional charge, because the vendor has assumed a risk which continues to be good and justified, is not at all clear. And if a credit risk turns out to be bad, how the addition of this surcharge to a net price which is already uncollectible helps matters is also not quite clear. However, it is argued, the point is that collections are speeded up by granting the allowance, or foregoing the surcharge, if bills are paid within the discount period, thereby reducing the number and amount of risks. But the majority of vendees who are able to and do discount their bills regularly are usually the ones who are in a sound financial condition, while those of precarious financial health probably would not discount their bills no matter what the inducements offered might be. So those whom we try to reach with this bait will not be tempted.

Gross sales prices are assumed to provide for all costs and expenses incident to carrying on in every business, and any risks entailed in the granting of credit should be, and usually are, covered by a reserve for bad debts.

Another interpretation of the surcharge theory is to the effect that the charge is for the work and services rendered by the accounting and credit departments. Of course, it would hardly be claimed by the most enthusiastic exponent of this idea that the work of bookkeeping and checking of credits applies only to accounts in the case of which offered discounts are allowed to lapse. If all the customers of a vendor who made provision for the recovery of these expenses by this method discounted their bills it would seem as though there might be no revenue to cover the expenses of these departments, which would continue to function in any event. Nor does there appear to be any merit in the necessary consequence that the charge for such service should be ten times as great in a sale of $250 as that in a sale of $25. Such claims are quite fantastic.

It is contended by those opposing the allowance theory that there are vital objections to it which necessitate a revision of the usual conceptions regarding cash discounts, as well as a change in their practical treatment. To meet such objections it is necessary to differentiate between purchase and sales discounts, or their complements regarded as surcharges, although it is not consistent nor in accord with fundamental principles.

The usual objections are that the practical application of the allowance theory overstates inventories; that the gross price is a fictitious figure while the net price only is of importance; that it results in recording savings which have no place in accounting records, and that it does not reflect the sum lost by neglecting to take advantage of the discount privilege, or rather the sum of the surcharges paid.

One of the most difficult problems confronting the auditor is found in the endeavor to arrive at sound conclusions respecting inventory valuations. Here, if anywhere, the accountant is called upon to exercise his most discriminating judgment. Without touching upon questions involving such intricate valuations as those relating to materials subject to obsolescence, to special materials acquired for particular purposes, or to materials the market price of which is subject to erratic fluctuations, it is difficult enough to value sound materials currently used. In the latter case the valuation principle of cost or market, whichever is lower, is generally applicable. If the surcharge theory is preferred, all materials purchased will be recorded at net prices and the inventory must be valued similarly; if the allowance theory is accepted gross prices will be used in both instances.

It must be remembered that it is just at the point of valuing inventories that every business comes into contact with the general productive field for the important factor of price determination for its own inventories, and there seems to be no justification for presuming that any special advantages or disadvantages attached to past purchases are also inherent possibilities relative to market prices or conditions of the replacement market as of the inventory date. It is a well established fact that market prices are quoted gross and that by and large in the entire commercial world such gross prices are the recognized values in exchange. Whether vendors offer discount privileges or not, and whether vendees are able to avail themselves of the discount privilege or not, such recognized values must be considered the ultimate standard of reference in the valuation problem. Cognizance must also be taken of the fact that in so far as costs play any part in determining prices, such costs must be based on gross prices and not on net prices. While in actual business practice the free play of economic laws is hampered and restricted, ordinary business conditions do tend toward the operation of economic laws, and it is evident in these circumstances, and to the extent to which economic laws impinge their influence upon every-day transactions, that prices will tend to be determined by the marginal producer. This producer operates under the most disadvantageous conditions, yet his product is necessary to supply the demand. It is safe and conservative to assume that he will not discount his bills, and that his merchandising cost will be based upon gross prices, as he will not recognize the so-called surcharge as anything other than a prime cost. In fact it might be a somewhat serious undertaking not to do so. It appears, therefore, that values in exchange are continually tending toward gross prices, and in view of these conditions it is not illogical to recommend the use of gross prices wherever market prices must be used for inventory valuations. With all due regard for conservatism, the gross market prices are, after all, the best criterion of value when consideration is given to all of the varying conditions of business operations. And as a corollary to the foregoing, producers who are able to command sufficient resources to enable them to discount all or a part of their bills receive a definite advantage which takes the form of income.

Perhaps something ought to be said concerning the validity of the allowance theory in such cases where discount rates are higher than two per cent.—say five per cent. or seven per cent. It has been contended that as the discount rate increases it reaches a point where it suffers a transformation and assumes the nature of a trade discount. The first difficulty encountered in any attempt to support that idea is the impossibility of fixing that point with any degree of certainty. If all conditions surrounding cash discounts remain constant, with the one exception that the rate be increased from two per cent. to four per cent., what logical reasoning will sustain a differentiation between cash discounts and trade discounts within those limits? Any change in those limits of the range of cash discounts leaves the same insurmountable obstacle. The second objection lies in the fundamental difference between the nature of a cash discount and a trade discount. A true cash discount is an allowance from the gross price for payment within a specified period, while a trade discount is a varying equalization factor applicable to more or less stable list prices to obtain current gross prices. So long as the stated discount terms, irrespective of rates, are enforced, i. e. an actual allowance is made for payment within the discount period or collection of the gross price after the discount period has elapsed, a true cash discount must be understood to obtain.

We are not concerned here with a justification for the practice of offering cash discounts, neither is it germane to the discussion to inquire why particular rates prevail, nor to determine any or all of the causes for the great variance in rates and other terms. But it is important to indicate, in a general way, that the existence of high discount rates does not vitiate the general principles of the allowance theory. The reason usually advanced for the assumption that high-rate discounts are not strictly cash discounts is that no business man would pay such a high rate for the use of money. Now that implies at least a subconscious tendency to evaluate cash discounts on the same basis as interest, which, as has been shown heretofore, is not strictly correct. However, grant for a moment that no business man would pay so much for money. It is then pertinent to ask, what does he pay for, where say an eight per cent. cash discount is offered which he does not or can not accept? Every argument which has been advanced against the surcharge theory gains in weight and force when applied to high-rate discounts.

From the vendee's point of view, the gross price as an entity, without any attempt to examine its inseparable elements, indicates to him what he must expect to pay for any desired goods, but he will avail himself of the most advantageous terms offered, everything else being equal. His position is more or less a passive one in the process of fixing cash discount rates and terms. Vendors are the prime movers in this process, and every vendor, to a greater or less degree, makes his estimates of the entire situation with respect to his operations in the light of his general comprehension of fundamental business relationships together with an analysis of the problems peculiar to his own business. Certainly he understands the relation between a rapid turnover of his accounts and inventories and gross profits and the advantages of increasing his volume of sales in this manner rather than by borrowing capital, which has its limitations. Rates, therefore, will depend upon how highly this turnover is valued, upon the percentage of gross profit earned in each turnover, and also upon the condition that the inducement to vendees to liquidate their liabilities must be attractive to become effective. The latter will probably always require an offering of a greater sum than that based upon current interest rates prevailing in particular industries, as well as in different localities. There is, therefore, no inconsistency in assuming that discounts at high rates are cash discounts, because the allowance will be commensurate with the advantages to be gained. From the surcharge point of view, no charge of six, eight, or ten per cent. will ever measure the disadvantages attendant upon, or compensate the vendor for, a retardation of turnover, while the allowance theory does definitely indicate to the vendor how much it has cost him to obtain the advantages of the quicker turnover, with all its implied benefits, to the extent that vendees do make the effort to discount their bills.

Finally, the argument that the important thing for the vendee to know is the amount of discounts lost, and that a revision of accounting procedures is essential for their determination, is not a sound reason for evolving a new theory. It must be confessed that knowing either one of the factors, i. e. discounts taken or discounts neglected, without knowing the other does not furnish sufficient information upon which to base conclusions. Only by making comparisons between total discounts offered, accepted and neglected can any definite conclusions be reached as to the efficiency with which this phase of the business is being administered. Certainly this information can be readily obtained without the help of a new theory. From the practical point of view, there is nothing in favor of the surcharge theory, as its application entails additional work in every instance.

Undoubtedly in many instances the granting of cash discounts is forced upon the vendors by trade practices and the methods of competitors. Otherwise it is a useful expedient to induce vendees to liquidate their liabilities and so enables the vendors to increase their rate of turnover which is one road to increased profits, the goal of every progressive concern. Expenses are entailed in every effort to promote and stimulate business, and so the cash discounts which are allowed by the vendors precisely in line with such endeavors are definite expenses to them.