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The old adage that accounts which fail to tell the truth are worse than no accounts at all is open to the wide interpretation as to what constitutes truth. The common method of handling commercial discounts has been to debit a merchandise discount account for all discounts taken by customers on sales which the business has made to them and to credit the merchandise discount account for all discounts which the business takes on purchases made from others. The counterbalancing entry, obviously, is a credit to the customer or a debit to the creditor for the amount of the discount. In many cases the more progressive bookkeeper has divided the merchandise discount account into a discount on sales account and a discount on purchases account; but the principle stated above still remains true. It is only the amount of the discount allowed or received that is recorded on the books of the business.

When it comes to the income statement there is considerable variation in the methods used by accountants. Discounts on sales are considered (a) as a deduction from gross sales in order to ascertain net sales, (b) as a selling expense and are included in the operating section of the income statement or (c) as a collection expense and are grouped among the administrative expenses of the business. Good arguments may be advanced perhaps for any of the methods mentioned. Discounts on purchases are either deducted from gross purchases, to ascertain the net purchases of the period, or are treated as a sort of interest income in the other-income section ot the income statement. The writer believes that in each case the element of discount should be added to the real sales or purchases to determine the net sales revenue or purchases outgo of the period; and the reason will be obvious as this discussion proceeds.

The purpose of accounting is to reveal the true condition of a business. But does the balance-sheet of a business, when presented to the proprietors or stockholders thereof, show all facts which are vital to the successful continuation of that business? Even when combined with the income statement, as ordinarily constructed, much of this information is lacking. The value of the assets and the amount of the liabilities, the net proprietorship, the earnings of the year, the gross sales and other interesting facts may be shown. But what is the credit condition of the business? Does it pay its bills promptly? Are its accounts receivable slow pay? Many such vital questions may arise in the mind of the stockholder, and it is the purpose of this paper to suggest one method by which some information of this nature may be obtained.

In the purchase and sale of merchandise a discount for quick payment is usually allowed. A few of our great corporations have standardized this rate at one-half of one per cent per month, but this can scarcely be considered a commercial discount as that term has been used and as it is usually understood. The ordinary discount makes quite a distinction between a quick and a slow payment. Thus, on a certain purchase a discount of 5 per cent may be allowed for payment within ten days, 3 per cent for payment within thirty days, or prices are net if paid within sixty days. The real value of the merchandise is the gross selling price less the maximum discount allowable. To state this another way, the man who pays his bill within the ten-day period is paying the value of the merchandise itself much more nearly than is the man who pays his bill at the expiration, let us say, of the sixty-day period. A business with good credit and with good management will see to it that the highest discount offered is taken, and if this discount is deducted from the gross purchases of the period the books will show a correspondingly low valuation for the merchandise. On the other hand, the business with such poor credit that it can pay its bills only at the last minute will be paying the maximum price for its merchandise, and it is very likely to happen that the business with the poorest credit will have the highest value for its merchandise on its books. This discount should not be considered as adding anything to the value of the merchandise, for the cost of manufacturing or distributing the goods sold to the sixty-day man can be no greater than that of the goods sold to the man who paid his bill promptly. The 5 per cent has nothing to do with the merchandise; it is entirely a payment for delay and for the risk involved. This infers that the merchandise should be charged to the merchandise or purchases account at the gross figure less the maximum discount allowed; and that is exactly what should be done. The gross cost should not be entered to the merchandise account even temporarily, but the discount allowed should be provided for in some other way.

This requires, in the treatment of purchase and sales discounts, a complete shift in the point of view from that usually maintained. Discounts taken on accounts payable are not profits, but neglected discounts are losses. Anyone could have purchased the goods at the minimum price. It is only because the business is unable to take advantage of these discounts that money is lost, and this is the fact that should be known to the proprietors or stockholders of that business. Likewise, discounts allowed on sales are not losses, but collected discounts are profits. The business is perfectly willing to sell any and all of its product for the gross price, less the maximum discount, and anything over and above that which is collected because of delayed payment on the part of the customers is pure profit. The sales account should be credited for only the amount which the business is willing to accept for a cash payment within the minimum discount period, for that is the real sale value of the merchandise. The balance is a payment by the customer for the risk assumed by the business on his account, and the books should show that fact.

In the case of public utilities, this question of discounts not taken or of forfeited discounts has been given considerable attention. No attempt is made here to exhaust the subject, and a few of the state regulations are referred to only as showing the trend in this direction. In the uniform classification of accounts for electric companies prescribed by the public service commission of Pennsylvania, effective January 1, 1919, account No. 333, under operating revenue accounts, is entitled "consumers' discounts forfeited and penalties imposed." It is prescribed for classes A, B, and C electric utilities, and provides:

"Credit to this account the amounts of those discounts the utility allows its consumers on condition that they pay their electric bills on or before a specified date, and which are forfeited by the consumers because of their failure to pay their bills within the specified time.

"Credit also to this account the amounts of penalties imposed by the utility on its consumers because of their failure to pay their electric bills within a stated time."

A similar provision is made for class D electric utilities through account No. 36 shown in the appendix to the regulations. The accounts do not definitely state how this income shall be reflected in the income statement, but it would undoubtedly be shown as a separate item, showing definitely the amount of revenue realized from this source. This would mean that the several accounts recording metered sales of electricity would be credited for the amount charged customers less the amount credited to the account No. 333 referred to above, thus showing in the several "metered sales" accounts the real value of the commodity sold.

The public service commission of Missouri, through its general order No. 12, effective January 1, 1915, and prescribing a uniform system of accounts for electrical corporations, provides revenue account No. 181, "discounts forfeited," to which shall be credited "all revenues derived from the forfeiture of discounts by consumers."

Other commissions, such as those of New Jersey and Maryland, maintain the old view and provide in substance that "credits to the various revenue accounts shall be made upon the basis of bills rendered or of gross prices," and that "discounts for prompt payment, corrections of overcharges, overcollections theretofore credited and afterward corrected," etc., shall be "charged to the revenue account to which they relate."

Still other state commissions, notably that of Colorado, in its uniform system of accounts for gas utilities, effective January 1, 1916, provide that "where it is the custom of the utility to grant a discount from the gross bill or to add a penalty to the bill where payment is not made on or before a prescribed date, such discounts or penalties shall be charged or credited" to the earnings from sales for (a) commercial lighting or (b) commercial fuel. However, "utilities desiring to do so may open sub-accounts to show the minimum bill and the discount or penalty items."

In this respect, then, while some state commissions have taken no definite action on the question, the trend is somewhat in advance of commercial accounting. Yet the commercial business, due to keen competition on all sides, has a far greater need of knowing definitely every source of income and every possible point of leakage. It is for this very reason that the commercial executive should have placed before him clearly the facts concerning neglected discounts on purchases and collected discounts on sales, as well as the discounts actually taken both on purchases and on sales.

The next question to consider, then, is the ease with which this information may be obtained. The principle is simple, and the two-column sales book and purchase book only will be used for the sake of illustration. Suppose a purchase is made of Hawthorne & Co., under date of Dec. 5th, amounting to $1,200.00, terms, 5/10, 3/10, n/60.

Purchase book

| Date | Folio | Acc'ts and explanation | Purchases | Purchase discounts allowable |
|---|---|---|---|---|
| Dec. 5..... | × | Hawthorne & Co...... | $1,140.00 | $60.00 |

The entry above is self-explanatory. Accounts payable (and Hawthorne & Co.) are credited for $1,200.00, merchandise purchases account is debited for $1,140 (the real value of the merchandise), and purchase discounts allowable is debited for the allowable discount, $60. At the end of the month the posting would be similar to that given for the one transaction above, and the individual creditors would be credited as from any other purchase book. In the cashbook there would be on the credit side of the book the ordinary column for accounts payable and the column for discounts taken on purchases. If a bill was paid within the credit period the discount would be taken, and the entry would be made exactly as has always been done for a similar transaction.

The sales book would be similar to that above shown, the two right-hand columns being entitled "sales" and "sales discounts allowable." The customers' remittances would be entered in the cashbook, as has always been done, and the discounts shown in the discounts taken on sales column when they were taken. There is no complication whatever in the method of handling either the purchase book or the sales book, and there would be no change from the usual method of handling the cashbook either for receipts from customers or for disbursements on account of accounts payable. The principle may be applied equally well to the multiple-column book, and to any of the various methods of handling purchase and sales invoices.

In the ledger either one or two accounts may be kept for the purchases and a like number for the sales. The writer prefers the four accounts, for there would be no question then concerning the meaning of the amount in any one of the accounts. The accounts might be entitled "purchase discounts allowable," "discounts taken on purchases," "sales discounts allowable" and "discounts taken on sales."

Suppose, to use the illustration above given, that the business paid the bill of Hawthorne & Co. thirty days after the purchase and received a 3 per cent discount thereby. If this was the only transaction for the period under consideration, the ledger accounts would stand as follows:

| Merchandise purchases | | | |
|---|---|---|---|
| 12/5 | $1,140.00 | | |

| Purchase discounts allowable | | | |
|---|---|---|---|
| 12/5 | $60.00 | | |

| Hawthorne & Co. | | | |
|---|---|---|---|
| 1/4 | $1,200.00 | 12/5 | $1,200.00 |

| Discounts taken on purchases | | | |
|---|---|---|---|
| | | 1/4 | $36.00 |

| Cash | | | |
|---|---|---|---|
| | | 1/4 | $1,164.00 |

The purchase discounts allowable account shows that the business was entitled to take a $60 discount, but the business failed to take that discount. As a result, instead of showing a $36 profit because of discounts taken on purchases, which is the common method of looking at the transaction, this shows that the business has lost $24 which it might have saved. Here is a leak that the business should know about, but under ordinary methods of accounting would not only not be known, but the management would tend to pat itself on the back because of the $36 profit it had made by taking the discount. The transactions of a month or of a longer period would show the same results and the ledger accounts would give information much more of value to the management than under the more common method of handling the accounts. Similar transactions might be used to illustrate the sales discounts allowable and the discounts taken on sales accounts, but the result is too obvious to require further illustration or explanation.

At the end of the monthly or fiscal periods the discounts taken on purchases account may be closed into the purchase discounts allowable. Any balance will be on the debit side of the account, and will show by how much the business failed to take advantage of the discounts that it might have taken. If advantage of every discount was taken, the accounts would obviously balance each other. This proves our thesis as above stated that the discounts taken on accounts payable are not profits, but that the neglected discounts are losses. For purposes of closing the ledger accounts and of preparing the manufacturing or operating statement the losses from neglected purchase discounts or the profits from collected sales discounts may be handled in the manner that the individual business or accountant desires. The writer prefers to attach them directly to the purchases and sales, so as to show the gross cost or return from these merchandising operations. If preferred, the loss from neglected discounts on purchases may be shown as an operating loss, or both the loss on the purchase discounts and the profit on the collected sales discounts may be included in the other income and expenditures section of the income statement. It is important to observe, however, that under the method here outlined the balance of merchandise on hand will be valued at the minimum price, regardless of whether advantage of the purchase discounts allowable was taken or not. To make the point perfectly clear, let us assume that the purchase of merchandise from Hawthorne & Co. consisted of 1,000 units of goods. Assume further that 900 of these units were sold at $1.50 per unit, that a 5 per cent discount was allowed on the sales, but that sales discounts of only $50 were actually taken by customers. The income statement might then appear as follows:

Income statement for month ended December 31st

| | | | |
|---|---|---|---|
| Sales, 900 units at $1.50, less 5% | | | $1,282.50 |
| Sales discounts allowable | $67.50 | | |
| Less: discounts taken on sales | 50.00 | | |
| Profit from collected discounts | | | 17.50 |
| Gross income from selling | | | $1,300.00 |
| *Contra:* | | | |
| Purchases, 1,000 units | | $1,140.00 | |
| Purchase discounts allowable | $60.00 | | |
| Less: discounts taken on purchases | 36.00 | | |
| Loss on purchase discounts | | 24.00 | |
| | | $1,164.00 | |
| *Less:* | | | |
| Inventory, 100 units at $1.14 (cost) | | 114.00 | |
| Gross merchandising cost | | | $1,050.00 |
| Gross profit on trading | | | $ 250.00 |

Now let us compare these results with what is usually shown. The ordinary trading statement would be somewhat as follows:

Income statement for month ended December 31st

| | | |
|---|---|---|
| Sales, 900 units at $1.50 | | $1,350.00 |
| *Less:* sales discounts | | 50.00 |
| | | $1,300.00 |
| *Contra:* | | |
| Purchases | $1,200.00 | |
| *Less:* purchase discounts | 36.00 | |
| | $1,164.00 | |
| *Less:* inventory (100 units at $1.20) | 120.00 | 1,044.00 |
| Gross profit on trading | | $ 256.00 |

Instead of a $17.50 profit because of allowable discounts collected from customers, this latter statement shows a $50 loss from sales discounts; and instead of a $24 loss because of neglected purchase discounts the management is priding itself because of a $36 profit. The inventory, which will appear in the balance-sheet, is 5 per cent overvalued in the latter statement. Real information concerning the ability of the business to take advantage of its discounts is shown in the former statement; the latter statement tells only one side of the story and the less important side at that. Concerning allowable discounts on sales, the former statement tells how many of these the business has succeeded in collecting, while the latter statement gives no information at all that would enable the management to keep in touch with this possible source of profits. The recording of possible discounts gives to the management and to the stockholders of the business information concerning certain conditions existing within the business that it is essential for them to have, yet the obtaining of that information, as outlined in the above simple scheme, is comparatively easy. The point to be remembered is that it is not the purchase discount taken which is so important from the standpoint of the management as it is the discount not taken, for the failure to take advantage of purchase discount may reflect an insufficient amount of working capital or other inherent weakness in the financial condition of the entire business.