

## APPENDIX

## 6B

## Control of Purchase Discounts

**P5** Apply the net method to control purchase discounts.

This appendix explains how a company can better control its cash *disbursements* to take advantage of favorable purchases discounts. Chapter 4 described the entries to record the receipt and payment of an invoice for a merchandise purchase with and without discount terms. Those entries were prepared under what is called the **gross method** of recording purchases, which initially records the invoice at its *gross* amount ignoring any cash discount.

The **net method** is another means of recording purchases, which initially records the invoice at its *net* amount of any cash discount. The net method gives management an advantage in controlling and monitoring cash payments involving purchase discounts.

To explain, when invoices are recorded at *gross* amounts, the amount of any discounts taken is deducted from the balance of the Merchandise Inventory account when cash payment is made. This means that the amount of any discounts lost is not reported in any account or on the income statement. Lost discounts recorded in this way are unlikely to come to the attention of management. When purchases are recorded at *net* amounts, a **Discounts Lost** expense account is recorded and brought to management's attention. Management can then seek to identify the reason for discounts lost such as oversight, carelessness, or unfavorable terms. (Chapter 4 explains how managers assess whether a discount is favorable or not.)

**Perpetual Inventory System** To illustrate, assume that a company purchases merchandise on November 2 at a \$1,200 invoice price with terms of 2/10, n/30. Its November 2 entries under the gross and net methods are

Gross Method		Net Method	
Merchandise Inventory . . . . .	1,200	Merchandise Inventory . . . . .	1,176
Accounts Payable . . . . .	1,200	Accounts Payable . . . . .	1,176

If the invoice is paid on November 12 within the discount period, it records the following

Gross Method		Net Method	
Accounts Payable . . . . .	1,200	Accounts Payable . . . . .	1,176
Merchandise Inventory . . . . .	24	Cash . . . . .	1,176
Cash . . . . .	1,176		

If the invoice is *not* paid within the discount period, it records the following November 12 entry (which is the date corresponding to the end of the discount period)

Gross Method		Net Method	
No entry		<b>Discounts Lost</b> . . . . .	24
		Accounts Payable . . . . .	24

Then, when the invoice is later paid on December 2, outside the discount period, it records the following

Gross Method		Net Method	
Accounts Payable . . . . .	1,200	Accounts Payable . . . . .	1,200
Cash . . . . .	1,200	Cash . . . . .	1,200

(The discount lost can be recorded when the cash payment is made with a single entry. However, in this case, when financial statements are prepared after a discount is lost and before the cash payment is made, an adjusting entry is required to recognize any unrecorded discount lost in the period when incurred.)

**Periodic Inventory System** The preceding entries assume a perpetual inventory system. If a company is using a *periodic system*, its November 2 entries under the gross and net methods are

Gross Method—Periodic		Net Method—Periodic	
Purchases .....	1,200	Purchases .....	1,176
Accounts Payable .....	1,200	Accounts Payable .....	1,176

If the invoice is paid on November 12 within the discount period, it records the following

Gross Method—Periodic		Net Method—Periodic	
Accounts Payable .....	1,200	Accounts Payable .....	1,176
Purchases Discounts .....	24	Cash .....	1,176
Cash .....	1,176		

If the invoice is *not* paid within the discount period, it records the following November 12 entry

Gross Method—Periodic		Net Method—Periodic	
No entry		<b>Discounts Lost</b> .....	24
		Accounts Payable .....	24

Then, when the invoice is later paid on December 2, outside the discount period, it records the following

Gross Method—Periodic		Net Method—Periodic	
Accounts Payable .....	1,200	Accounts Payable .....	1,200
Cash .....	1,200	Cash .....	1,200

## Summary

**P5<sup>B</sup> Apply the net method to control purchase discounts.** The net method aids management in monitoring and controlling purchase discounts. When invoices are recorded at gross amounts, the amount of discounts taken is deducted from the balance of the Inventory account. This means that the amount of any discounts lost is not reported in any account and is unlikely to come to the

attention of management. When purchases are recorded at net amounts, a Discounts Lost account is brought to management's attention as an operating expense. Management can then seek to identify the reason for discounts lost, such as oversight, carelessness, or unfavorable terms.



### Key Terms

[mhhe.com/wildFAF2e](http://mhhe.com/wildFAF2e)

Key Terms are available at the book's Website for learning and testing in an online Flashcard Format.

Discounts lost

Gross method

Net method

**Multiple Choice Quiz**

Answers below

[mhhe.com/wildFAF2e](http://mhhe.com/wildFAF2e)**Additional Quiz Questions are available at the book's Website.**

- 5.<sup>B</sup> A company records its purchases using the net method. On August 1, it purchases merchandise on account for \$6,000 with terms of 2/10, n/30. The August 1 journal entry to record this transaction includes a
- a. Debit to Merchandise Inventory for \$6,000.
  - b. Debit to Merchandise Inventory for \$5,880.
  - c. Debit to Merchandise Inventory for \$120.
  - d. Debit to Accounts Payable for \$5,880.
  - e. Credit to Accounts Payable for \$6,000.

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**QUICK STUDY**

An important part of cash management is knowing when, and if, to take purchase discounts.

**QS 6-9<sup>B</sup>**

Purchase discounts



- a. Which accounting method uses a Discounts Lost account?
- b. What is the advantage of this method for management?

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**EXERCISES**

World Imports uses the perpetual system in accounting for merchandise inventory and had the following transactions during the month of October. Prepare entries to record these transactions assuming that World Imports records invoices (a) at gross amounts and (b) at net amounts.

**Exercise 6-13<sup>B</sup>**

Record invoices at gross or net amounts



- Oct. 2 Purchased merchandise at a \$5,600 price, invoice dated October 2, terms 1/10, n/30.
- 10 Received a \$900 credit memorandum (at full invoice price) for the return of merchandise that it purchased on October 2.
- 17 Purchased merchandise at a \$5,950 price, invoice dated October 16, terms 2/10, n/30.
- 26 Paid for the merchandise purchased on October 17, less the discount.
- 31 Paid for the merchandise purchased on October 2. Payment was delayed because the invoice was mistakenly filed for payment today. This error caused the discount to be lost.

**ANSWER TO MULTIPLE CHOICE QUIZ**

5. b; The entry follows.

Merchandise Inventory* . . . . .	5,880
Accounts Payable . . . . .	5,880

\* $\$6,000 \times 98\%$