

# McLean, Koehler, Sparks & Hammond

Certified Public Accountants/Business Consultants

## Industrial Manufacturing

### Be sure your accounting method handles discounts – or pay more tax

How your accounting system handles discounts you receive when you purchase items for resale can affect the amount of income taxes you pay.

#### How your accounting system handles discounts can affect your cash flow.

Suppliers offer discounts for a number of reasons:

- **Cash discounts** – allowances extended by a vendor to encourage payment of an invoice on or before a stated date that is earlier than the normal due date.
- **Quantity discounts** – allowances extended by a vendor on the basis of the quantity or value of a purchase, irrespective of when payment is made.
- **Trade discounts** – reductions in the established prices of items allowed by the vendor, irrespective of when payment is made. The discount may vary with the volume of the purchase.
- **Rebates or incentives** – incentives offered by a vendor to encourage the purchase of goods from that supplier.

Generally, taking advantage of discounts offered by your suppliers benefits your business because it reduces your overall cash cost. But how your accounting system handles these discounts can also affect your cash flow – by determining when you pay your income taxes on the benefit you obtain from the discount.

Most businesses account for discounts in one of two ways:

1. The accounting system assumes that all discounts will be taken and the cost of the inventory purchased is reduced by all available discounts. Discounts not taken are treated as an expense in the year the discount is forgone. When you later sell the inventory, the discount results in a higher profit on the sale.
2. The purchase cost of the inventory is recorded at its standard, i.e., non-discounted, price. Discounts taken are recorded as profit in the year the discount is obtained.

If you use the first method, income taxes attributable to the discount are not paid until the inventory is deemed sold under your method of accounting, which may be FIFO, LIFO, average cost or specific identification.

If you use the second method, the income taxes may be paid earlier if the discounted item is deemed to remain in your inventory as of the end of the year in which the discount is taken. See the chart below for a simplified calculation of the tax effect of the two methods.

Either method of accounting for discounts is acceptable for federal income tax purposes.

The catch is that the method you use for tax purposes must be the same method that you use in your financial reports. So you can't choose Method 1 for tax reporting and Method 2 for financial reporting.

If you are currently using Method 2 and would like to switch to Method 1, you must obtain the OK from the IRS to change accounting methods.

How your accounting system handles discounts can affect your cash flow.

## Tax effect of accounting for discounts – A comparison

Coyote Supply Company sells a variety of traps and explosive devices suitable for capturing or maiming roadrunners.

Most of the products sold by CSC are manufactured by Acme, Inc.

In an effort to clear out its warehouse before the end of the year, Acme offers CSC a \$100,000 discount if CSC purchases and accepts delivery of Acme products with a total list price of at least \$1 million before the end of the current year.

The Acme products will be sold by CSC next year for \$1.2 million. CSC is in the 40-percent combined federal and state income tax bracket.

Assuming CSC accepts Acme's offer this year and re-sells the products next year, the effect of the discount on CSC's tax liability this year and next depends on whether CSC accounts for purchase discounts under Method 1 or Method 2.

Method 1 defers taxation of the benefit of the discount until the inventory is deemed sold under CSC's method of accounting. If CSC uses the FIFO inventory method, the benefit may be no more than a one-year deferral. However, if CSC uses the LIFO method, the deferral could be significantly longer. That's because LIFO assumes that goods purchased next year are sold before this year's purchase.

<b>Method 1</b>	<b>This year</b>	<b>Next year</b>
Selling price		\$1,200,000
Cost of goods sold		(900,000)
Gross profit		300,000
Discounts taken		
Taxable income		300,000
Tax @ 40%		\$120,000
<b>Method 2</b>	<b>This year</b>	<b>Next year</b>
Selling price		\$1,200,000
Cost of goods sold		(1,000,000)
Gross profit		200,000
Discounts taken	\$100,000	
Taxable income	\$100,000	\$200,000
Tax @ 40%	40,000	80,000

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