

FINANCE AT A GLANCE

What is an EXPENSE ?

Lesson 17

In order to explain what an EXPENSE is, it is best to start with clear examples. Think of a trading company that acquired goods for \$700 in December 2007, and sold the same for \$1,000 in January 2008, after having placed an ad that costs \$100 in January. Here, there were two expenses: Cost of Good Sold (\$700) and Advertising Expense (\$100). Both of these expenses should be reported and recognized in the same period as when the goods were shipped to the customer. The \$700 was not an expense in 2007, but an expense in 2008, even if it had paid to the supplier before the start of 2008. This is what the accrual concept is about.

Now, let us have an example of a manufacturing company that was at the set-up stage early in 2008. It costs a total of \$1 million to buy the manufacturing equipment, and that was paid for in 2008. Using the equipment, the company manufactured and sold goods in 2008. That amount of \$1 million for the equipment was not an expense for reporting in 2008. However, we know that the use of the equipment resulted to some wear and tear. If the useful life of the equipment was forecast to be 10 years, then only a portion of that useful life was used up in 2008. Only that part of the value of the equipment is needed to be recognized as expense in 2008. That expense is what we call **Depreciation Expense**. Now we see clearly how the accrual concept aims to match expenses with revenues that belong to the same period. It would be wrong to charge the full \$1 million value of the equipment in 2008, because we knew that the same equipment would still be in productive use in the years to come.

Raw materials (and labor) were used to produce the goods. If the raw materials costing \$50,000 were acquired during the previous year, and only half of those were used in making the products sold in 2008, then only that half of the cost of raw materials purchased was to be considered an expense in 2008.

The next several e-lessons will focus on the various types of revenues and expenses.

Until then,

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