

FINANCE AT A GLANCE

Computing Cost of goods sold (1)

Lesson 22

The most complex expense item in the income statement is the so-called cost of goods sold (or cost of sales for service business).

In a trading business, the computation of cost of goods sold, which is based on values of purchases and stocks, is more or less straightforward. In a manufacturing business, the computations are more complicated. All costs linked to the creation of a product such as factory wages, maintenance, factory rent, and many types of factory expenses must be thrown into the calculation along with the cost of materials.

We begin our discussion with cost of goods sold in the context of a trading business. In a trading business, we only have finished goods to deal with. (In a manufacturing business, we need to consider good-in-process and raw materials.)

To understand the following discussion, think of the stock of finished goods, and bear in mind the equation below, which represents the physical change in the quantity of the stock of finished goods.

(1) Beginning stock + Purchases = Sold stock + Ending stock

It means that the stock currently on hand (beginning stock) plus additional stock (resulting from purchases) must equal to the sum of the sold stock and the remaining stock (ending stock). In reality, the left side equation may be higher than the right side, which means that some of the stock must have gone astray (probably lost or stolen), or simply considered unsaleable. To account for this reality, we modify the equation as follows:

(2) Beginning stock + Purchases = Sold stock + Ending stock + Lost stock

This equation can be rewritten as follows:

(3) Beginning stock + Purchases - Ending stock = Sold stock + Lost stock

The monetary value of the stock sold and lost is what we call cost of goods sold. Converting the above equation in terms of \$, we arrive at the equation which defines cost of goods sold:

(4) Beginning stock in \$ + Purchases in \$ - Ending stock in \$ = Cost of goods sold

This leads to the question: Why do we consider the value of the lost stock to be part of cost of goods sold, when that stock was in fact lost and not sold? Answer: By considering the cost of the lost stock part of the cost of goods sold, we, as a matter of fact, "inflate" the cost of the stock actually sold, thus, yielding a conservative value of the business' profitability.

We also see from Equation 4 above that cost of goods sold is a derived figure based on the monetary value of the beginning stock, plus the monetary value of purchases within the period, minus the monetary value of the ending stock. We do not arrive at the cost of goods sold by simply multiplying the units sold during the period by the cost per unit paid to supplier for those units. For example, even if we know that 100 units were sold in January and that \$50 per unit was paid to the supplier, we do not simply multiply 100 units by \$50 to arrive at the cost of goods sold. The following lessons will elaborate on this.

Until then,

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