

FINANCE AT A GLANCE

Expenditure vs. Expense vs. Cost

Lesson 26

At this stage, a clarification of terms such as **expenditure**, **expense** and **cost** is in order before we carry on with the rest of the items in the income statement.

An expenditure simply means the use of cash to pay for an item. An expenditure can either be an expense or a cost.

An expense is an expenditure that directly decreases income. They are expenditures for advertising and selling products, paying salaries, buying supplies for the office and the R&D laboratory, and so forth. They are presented as operating expenses in the income statement.

A cost, on the other hand, is an expenditure that does not enter the income statement directly. A cost enters the asset side of the balance first, and only portions of it enter the income statement. This can be explained as follows:

We incur costs to buy or make products for inventory. For a trading business, costs are incurred when we buy stocks for the inventory. For a manufacturing business, costs are incurred due to raw materials purchase, workers' wages and factory overhead. All of these manufacturing costs are added to the inventory (as shown in the preceding lesson). When part of the inventory is sold, that means, shipped to customers, the cost ascribable to the products sold are taken out of the inventory and entered into the income statement as a special type of expense called *cost of goods sold*, which was already covered in previous lessons. (Even if its name begins with the word "cost", it is indeed an expense.)

We also incur cost when we purchase capital assets, like equipment. The purchase cost of the equipment appears on the balance sheet. If the equipment is used in manufacturing, a certain portion of that cost is taken out to take into consideration the wear and tear for the period covered by the income statement, and that portion forms part of the manufacturing overhead. That portion is called *depreciation*. If the equipment is used by non-manufacturing personnel, the depreciation enters the income statement as part of the operating expenses (which will be discussed later).

Understanding the difference between cost and expense will make it easy to understand how the income statement and the balance sheet work together (a topic which will be covered in a future lesson).

Until then,

Info Solutions International