

Visual Learning Maps

Introductory Financial Accounting



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VIRTUAL TEXT BOOK

COST OF GOODS SOLD "COGS" – 1 OF 5

Some businesses sell services. Consultants, physicians, carpenters, accountants, banks, entertainers, airlines, and hotels - are just a few examples of businesses that sell services. These businesses do not use "COGS" in their income statement.

Other types of businesses sell **things**; these **things** are called goods or products. In Accounting language businesses that sell goods are called "Merchandising" enterprises. Merchandising operations can be retail or wholesale. Some of these businesses manufacture their own products some don't. These businesses sell a wide variety of things that you see all around you every day: food, clothing, cosmetics, software, hardware, boats, vehicles, and so on and so on. Some of the largest companies in the world are merchandising operations. Coca Cola, Microsoft, General Motors, Kellogg's are a few examples.

All merchandising companies use COGS. Why? To answer this question:

"What did the stuff we sold cost us?" ←

Whether a business is selling cola, software, vehicles or boxes of corn flakes; the accounting system **must** answer this question. ←

Here's why:

Businesses want to know how much profit was made on the **things** they bought, and then sold. This is called **Gross Profit or Gross Margin**. The meaning of the word "Gross" in this context is – the difference between what the business paid for the products it purchased and the total sales generated by those same products. Gross Profit or Gross Margin tells the owners or management the amount and most importantly the **percentage profit** before Operating Expenses. These include categories of expenditures: Selling, General and Administrative; such as: rent, advertising, marketing, depreciation, administration salaries and wages, sales salaries, repairs, travel supplies and so on, and so on.

To derive Gross Profit or Gross Margin – COGS must be calculated

SEE CLASS NOTES: MULTI-STEP INCOME STATEMENT

"COGS" – The Theory & Terminology – 2 OF 5

The business wants to know the cost of just the items sold, not the cost of all the items it has – so inventory must be taken into account. COGS is **always** a monetary figure - **always** expressed in **Dollars, not units**.

But to understand COGS, think of units first. It doesn't matter if the business sells bicycles, pens or BMWs – at the start of the accounting period there were some pens ready to be sold (in inventory); and at the end of the accounting period there were some pens ready for sale (in inventory). During the accounting period there were many pens purchased from the supplier to be sold, and many pens were sold during the period.

So - If at the start of the accounting period the business had 1,000 pens on the shelf ready for sale (in inventory), and during the accounting period the business bought 12,000 pens from its wholesale supplier to sell to its retail customers, and at the end of the accounting period there were 2,000 pens on the shelf ready to be sold (in inventory) – how many pens did the business sell?

Well – during the period the business started with 1,000 then purchased 12,000; which means that the business had 13,000 pens ready to sell to its customers during the period. These were the total **goods available for sale**. But there were 2,000 pens still left at the end of the accounting period, so the number of pens actually sold was the number of pens available for sale **less** the number of pens of pens still on hand, not sold: $13,000 - 2,000 = 11,000$

Let's say that each pen cost the business \$2 and convert the above example to Accounting language.

BEGINNING INVENTORY (the value of the pens the business stated with 1,000 x \$2)	\$ 2,000
	+
PURCHASES (the value of pens bought from the supplier 12,000 X \$2)	<u>\$24,000</u>
COST OF GOODS AVAILABLE FOR SALE	\$26,000
LESS: ENDING INVENTORY (pens left – not sold: 2,000 X \$2)	<u>\$ 4,000</u>
<u>COST OF GOOD SOLD</u>	<u>\$22,000</u>

Number of pens sold X \$2

"COGS" – continued – 3 OF 5

PURCHASE RETURNS & PURCHASE ALLOWANCES

The Accounting model fits itself to reality – it does not change reality to fit it.

In reality, sometimes suppliers send merchandise that is not what the business ordered. The business may have ordered 500 pens and received 800. Or, the supplier may have delivered 500 pens, but they are blue pens and black pens were ordered.

Purchase Returns and Allowances are typically about the wrong quantity received or the quality / specifications of the merchandise received. Late delivery can also be a cause.

When the business receives the wrong quantity or "blue pens instead of black pens," the business then decides whether or not to return the merchandise. If it returns the entire order or part of it, it is accounted for as a purchase return. In the continuing example, if the business decides to return 300 of the 800 pens, it would record the following entries:

Purchases Account ($\$2 \times 800$) debit $\$1,600$ [credit accounts payable $\$1,600$]

Purchase
Returns Account ($300 \times \$2$) credit $\$600$ [debit accounts payable $\$600$]

OR...

Once a conversation occurs with the supplier, the business may decide to keep the extra 300 pens or to keep the blue pens because the supplier has offered an **Allowance** on the order as an incentive to the business to avoid costly return shipping costs to the supplier. In the continuing example, let's say the supplier offers 15% off the extra pens delivered ($\$600 \times 15\% = \90). This is a Purchase Allowance. If the business agrees to the deal with the supplier, the business would record the following entries:

Purchases Account ($\$2 \times 800$) debit $\$1,600$ [credit accounts payable $\$1,600$]

Purchase Returns & Allowances
Account ($\$2 \times 300 \times 15\%$) credit $\$90$ [debit accounts payable $\$90$]

Purchase Allowances relate to the business making a deal with the supplier to accept merchandise that is either 1) not the quantity ordered or 2) does not meet the specifications of the order. Late delivery can also be a cause.

"COGS" – continued – 4 OF 5

PURCHASE DISCOUNTS

Purchase Discounts relate to payment by the business to the supplier within a time frame specified by the supplier.

Some suppliers invoice the business with the option to the business to pay within a specified time period after the goods are received by the business - and if the business does pay within the time period, the business receives a discount from the supplier.

For example: if the business pays the supplier within 15 days, the business receives a 2% discount.

SEE CLASS NOTES: PURCHASE RETURNS, ALLOWANCES & DISCOUNTS

A GOOD QUESTION

Why is it necessary to complicate things by accounting for Purchases, Purchase Returns and Allowances and Purchase Discounts separately; why not account for them all in one account and net everything - wouldn't that be simpler?

ANSWER

It would be slightly simpler because there would be fewer accounts to keep track of in the bookkeeping process. **Remember Accounting is about tracking reality.**

Important reality information would be lost. Here's why: the % relationship between Returns & Allowances and Purchases is critical to know. If Returns & Allowances are, for example, 30% of Purchases - there is something wrong with your supplier. If the inventory you have for sale is defective or not on the shelf when your customers are ready to buy - you will lose customers. This is not good, so watch the R&A %; it speaks.

The % relationship of Purchase Discounts to Purchases also speaks. It tells the business how well, or not, it is doing in taking advantage of supplier discounts. This is about managing cash flow. The less cash spent, the more cash is retained. Taking advantage of discount opportunities is a key managing task.

"COGS" – continued – 5 OF 5

FREIGHT IN COSTS also called Transportation In

When suppliers sell merchandise to a business, the contract specifies who will pay the cost of delivering the merchandise.

The standard term to define who is responsible for shipping costs is: **FOB Destination** or **FOB Shipping Point**.

FOB means, "**F**ree **O**n **B**oard."

FOB Destination means that the supplier pays the delivery cost to the merchandising business. In this case the merchandising business does not record the delivery cost as a separate item in the COGS.

Confusion Trap

Freight In is always part of COGS. These costs are attached to the cost of inventory. The costs relate to purchasing merchandise inventory for resale from suppliers.

There are also freight costs in some business when merchandise is sold and **delivered to customers**. These costs are **not** Freight In. These are selling costs - part of Operating Expense. They could be called "Freight Out."

Calculating COGS

Opening Inventory + Cost of goods Purchased - Closing Inventory = COGS

Cost of goods Purchased = Net Purchases + Freight In

Net Purchases = Purchases - Purchase R & A - Purchase Discounts

SEE CLASS NOTES: COGS - HOW TO REMEMBER THE COLUMNS & WHAT GOES IN EACH COLUMN