Module 1: Notes 3 - External Reporting of Costs

Module Notes: External Reporting of Costs

Generally Accepted Accounting Principles (GAAP) must be followed for external reporting. You will be introduced to how costs are classified and reported in the financial statements that are reported externally. Although these concepts apply to manufacturing, merchandising and service companies, manufacturing companies have additional classifications of costs related to the conversion of raw materials into finished goods.

Cost Classification

The costs of a manufacturing company can be categorized as product costs and period costs.

- **Product costs** are all costs associated with manufacturing the product. Examples include materials that are used to make the product, wages for workers who make the product, utilities for the manufacturing facility, etc. Product costs are reported as inventory on the balance sheet until the finished product is sold. For this reason, product costs are also referred to as inventoriable costs.
- **Period costs** are all costs not related to the purchase or manufacture of the product. Examples include costs related to sales, marketing, and corporate functions (such as human resources, finance, and information technology) who provide support company-wide. Period costs are reported as expenses on the income statement in the period incurred.

Refer to **Exhibit 2-16** in the assigned textbook for more information on the flow of costs through a manufacturing company's financial statements.

Product Costs

Product costs include all costs related to the purchase or manufacture of products. Manufacturing costs are comprised of direct material costs, direct labor costs and manufacturing overhead.

- **Direct material costs** are the acquisition costs of all materials that eventually become part of the cost object and can be traced to the cost object. Computer chips that are used to make cellular phones is an example of direct materials.
- **Direct manufacturing labor costs** include the compensation of manufacturing labor directly involved in the conversion of raw materials into finished goods, and can be traced to the cost object. Wages and fringe benefits paid to machine operators is an example of this.
- **Manufacturing overhead** are all manufacturing costs that are related to the cost object throughout the process, but cannot be easily traced to the cost object. Examples include costs of the manufacturing facility (such as utilities and property taxes), supplies and materials used in the manufacturing process (such as glue and thread) that cannot be traced to the cost object, and the compensation of employees who are indirectly involved in the manufacturing process (such as plant supervisors and plant janitors).

Direct materials and direct labor together are often referred to as **prime costs**. Whereas, direct labor and manufacturing overhead together are often referred to as **conversion costs**.

Balance Sheet

Product costs are assigned or allocated to cost objects and reported in inventory accounts until the product is sold. A merchandising company has one inventory account. However, a manufacturing company maintains three types of inventory:

- **Direct materials inventory**: Materials in stock and awaiting use in the manufacturing process
- **Work-in-process inventory**: Products that are in the manufacturing process but not yet completed
- **Finished goods inventory**: Products that are completed but not yet sold

Merchandising Company
Balance Sheet
December 31, 2019

Current Assets	
Cash	150,000
Accounts Receivable (net)	200,000
Inventory	650,000
Prepaid Expenses	50,000
Total Current Assets	1,050,000

Manufacturing Company
Balance Sheet
December 31, 2019

Current Assets		
Cash		200,000
Accounts Receivable (net)		400,000
Inventory		
Raw Materials	90,000	
Work-In_Process	175,000	
Finished Goods	250,000	
Total Inventory		515,000
Prepaid Expenses		105,000
Total Current Assets		1,220,000

Income Statement

Once the product is sold, the **product costs** are moved from finished goods inventory (on the balance sheet) to cost of goods sold (on the income statement). Cost of goods sold is the cost of finished goods inventory sold to customers during the current accounting period. Cost of goods sold are deducted from revenues resulting in gross margin.

Period costs are reported as operating expenses on the income statement. Operating expenses are deducted from gross margin resulting in operating income.

Refer to **Exhibit 2-12 to 2-19** in the assigned textbook for more information on the Income Statement and the calculation of Costs of Goods Sold.