Expenditures, Costs, and Expenses

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Some terms that commonly cause confusion are "expenditures", "costs", and "expenses". The distinction of those terms is of essential importance, though. Bellow, I attempt to clarify these terms and provide some relevant examples. Moreover, I discuss the so-important difference between "product/service costs" and "period costs".

Expenditures

An expenditure is the sacrifice of economic resources to achieve a goal. For example, when a maritime firm purchases a vessel, it makes an expenditure. Therefore, expenditure is to sacrifice some economic resources with the expectation to receive some benefits either in the present or in the future. Note that the economic recourses are not necessarily in the form of cash when the arrangement is made. For example, the maritime firm may have signed a note payable with a one-year maturity.

Costs

Every time that a firm makes an expenditure, the firm incurs a cost. The cost is the outcome of the expenditure. For accounting purposes, we typically use the term "cost" by far more frequently than the term "expenditure". In my previous example, the expenditure of acquiring the vessel entails a cost of CU1,000,000 for the firm.[1] Another important remark is that costs are distinguished in product (or service) costs and period costs. I will return to this latter.

Expenses

Expenses are recognized when we feel that cost contributes to the creation of revenues. Therefore, an expense is a cost that is expensed (i.e. consumed) to yield a revenue. This follows the matching principle which states that "expenses are recognized when they create revenues". The above reasoning implies that every expense was previously a cost (but not the opposite).

In my previous example, the acquisition of the vessel was a significant cost for the firm. However, this will not be converted to expenses unless the firm feels that the vessel contributes to the creation of revenues, that is, the vessels starts providing transportation services.[2] In a similar vein, for merchandise firms, the purchase of merchandise is a cost but not an expense until the merchandise is sold and creates revenues.

Product/Service costs and Period costs

A very important concept is the distinction of costs in product (or service) costs and period costs. This distinction is very essential because it indicates the time that the accounting system believes that the cost has contributed to the creation of revenues and therefore, is converted to an expense.

Product/service costs are the costs considered as necessary to produce the product or the service that the firm sells. This means that every cost necessary to produce the products or the services will be expensed *if and only if* the product is sold or the service is provided.

In my previous example, the cost of the vessel is a "service cost", that is, part of the production of the service, and therefore, it will become an expense *if and only if* the vessel starts operations. In merchandise firms, we have no production process. Conventionally, we consider as production cost the purchase cost of the merchandise. Therefore, the cost of merchandise will be expensed *if and only if* the merchandise is sold to the customer.

Period costs are the costs related to the administration and the selling activity of the business. They are not directly related to the production of the products or the services. For example, the accountant's salary is a cost which is not directly related with the service provision. It is actually part of the administration activity. Similarly, the salaries for the selling staff are part of the selling activity. For accounting purposes, period costs are expensed in the period they occur as they are not directly related to the products or services.[3]

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[1] CU stands for "Currency Units".

[2] Note however, that the vessel will provide services for many years and therefore, its cost should be expensed gradually.

[3] Apparently, the above discussion means that the classification of a cost as a product/service cost or period cost is of utmost importance as the classification will determine when the cost will be expensed. Although the distinction seems straightforward at a first glance, real world costs may be more complicated and hard to say where they belong but this is beyond the scope of this course.

Next, I provide a numerical example. Moreover, all the above concepts are summarized in Figure 1.

Numerical Example

I will consider a maritime firm which provides transportation services. I will limit my analysis into two costs, namely the salary of the firm's accountant and the fuel cost of a vessel. This is for expositional convenience, but the rationale applies to all costs.

Information provided

On January 1, the firm hired an accountant with a monthly salary CU3,000. The firm also purchased fuel supplies at a cost of CU1,000 for the vessel XYZ.
During January the vessel XYZ did not make any transportation.
During February, the vessel XYZ provided some transportation services and consumed 80% of the fuel.
What is the expense of each month?

Answer

The accountant's salary is not directly related to the provision of transportation services. Therefore, it is considered as part of the administration activity (i.e. a period cost). Conversely, the fuel cost is directly related the provision of transportation services and therefore, it is part of the production activity (i.e. a service cost). This means that the former will be expensed in the period it occurs, whereas the latter will be expensed when the service is provided. This reasoning yields the following result:

Month	Expenses
January	CU3,000 (the accountant's salary for January)
February	CU3,800 (the accountant's salary for February and 80% of the fuel cost)

Figure 1: Expenditures, Costs, and Expenses