Financial Accounting
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Lecture – 52
5.2 Tutorial – Identifying Direct and Indirect Expenses

This is a tutorial; in this tutorial I am going to talk about direct and indirect expenses. In the last video, you saw the format that we are going to use for a profit and loss account. In that account, there is a section where we show direct expenses and there is another section where indirect expenses are shown.

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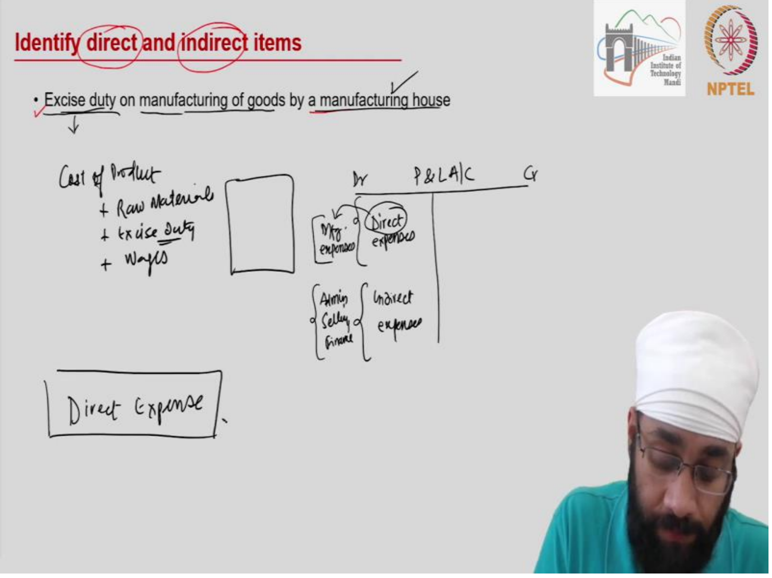

So, it is important that we have a better understanding of what are direct expenses and what are indirect expenses. On the slide, a transaction is given: name of an expense is given and some explanation along with it and we have to identify if the expense is direct or indirect in nature.

Before we solve this, let me quickly reemphasize the definition of direct and indirect. This is the profit and loss account, P&L A/c. You have a credit side and a debit side. In the previous video, we said that the first half of the profit and loss account is going to show direct expenses. And, the second half will show indirect expenses. And, the definition of the direct expenses is anything related to getting the goods ready to be sold. So, up till manufacturing all manufacturing or factory related expenses are direct expenses. Whatever comes after that, all the administrative expenses, all the selling expenses, finance costs, etc. are going to be called indirect expenses. Thus, the qualifying criteria is whether this expense is contributing towards the cost of the product or towards the cost of selling the product i.e., cost of managing the product after it has been produced. Whatever contributes directly to the cost of the manufacturing of the goods is called a direct expense. That is how you distinguish between the two types of expenses. Now, let us look at this expense. Excise duty on manufacturing of goods by manufacturing house. Excise duty is paid on anything that is manufactured, produced on Indian soil. So, that is a requirement. Different kinds of goods have different percentages of excise duty applied on them. Clearly this is being done during the manufacturing. So, the cost of the product is going to include the raw materials and you are going to add to it the excise duty as well. Excise duty, whatever else, whatever wages you pay on getting the goods manufactured. So, excise duty is part of the cost of the product. It directly contributes to the cost of the product which is being manufactured by this manufacturing house. Therefore, we are going to categorize this into direct expense and that is our answer.

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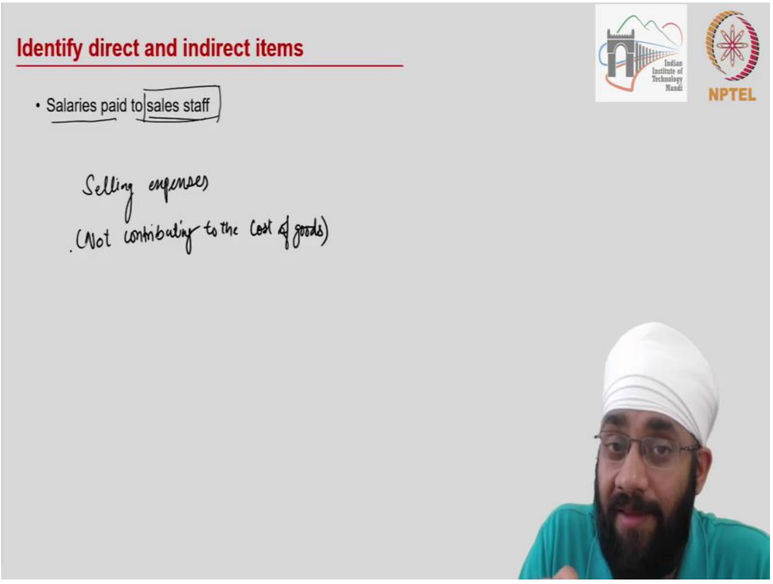

Let us look at another expense. Salaries paid to sales staff. Now, the salaries are being paid to the sales staff, clearly sales staff is going to help in selling the goods not manufacturing the goods, and whenever expenses are being done on non-manufacturing functions, we call them indirect expenses. So, salaries paid to sales staff will come under selling expenses, and these are not contributing to the cost of the goods. This is not the cost of the goods, this is an additional expense. Of course, you could come back and argue that the selling expenses also increase the cost of a business or selling that product, that is fine. That is another argument, the total cost. But we are segregating the two types of cost.

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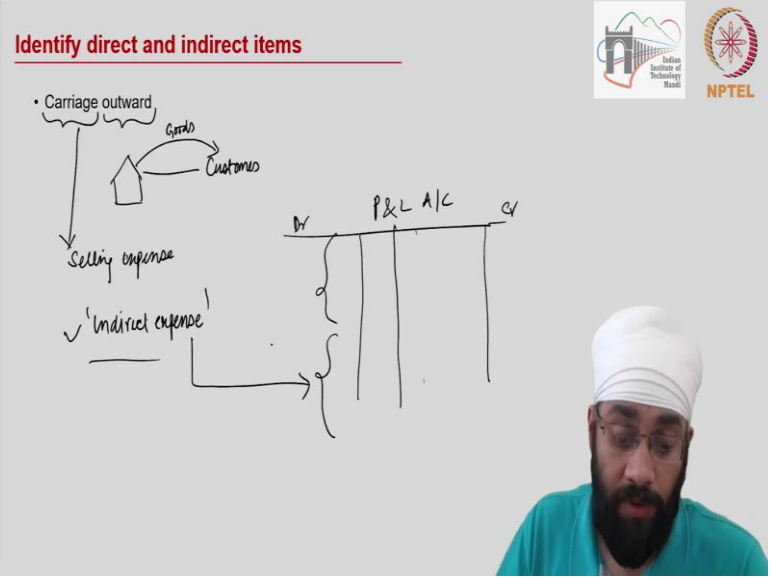

The next item is carriage outward. Carriage is the transportation expense, transportation cost, and outwards refers to the direction of the goods. So, business sells goods to the customers, and when you sell the goods the direction of the goods is outward. So, goods are going out of business and goods are being shipped and you pay those shipping charges, that is your sales policy, you take care of the delivery, free delivery policy, but you have to bear those expenses. Carriage outward is helping you sell, it is a kind of selling expense because when you offer free delivery to people, then you are expecting more sales to take place. Clearly this is not relating to the manufacturing of the goods. Therefore, we are going to categorize this as indirect expense. And, it is going to be shown in the second half of the profit and loss account. I keep drawing this T, because this is a representation of the account. So, credit side, debit side, you will have an amount column, or date column, and so on. That is how the account looks.

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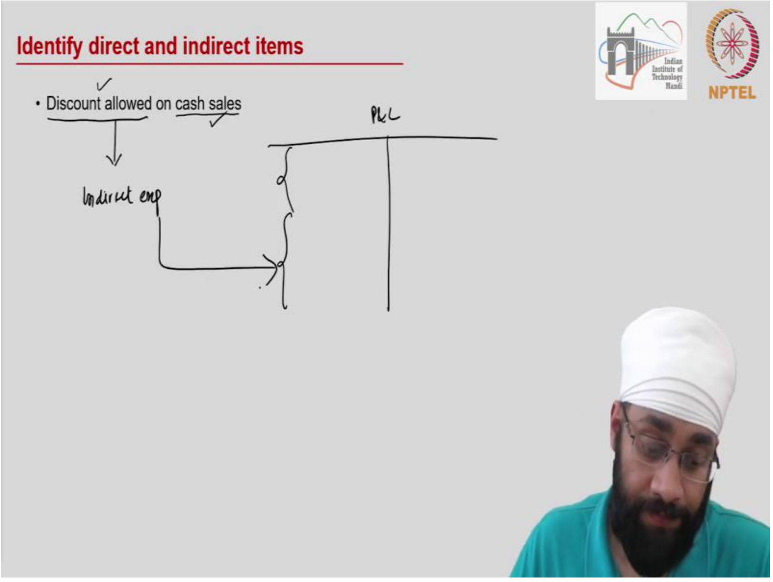

The next item is discount allowed on cash sales. So, sales are happening and discounts are being allowed. Why do you allow discounts? In the first place- to incentivize your customers to pay you the money or to sell more, you are reducing the price of the goods, so that people buy immediately from you or buy more quantities from you. Again, this is clearly a sales strategy, as selling expenses. So, we are going to categorize this into indirect expense. And, in the profit and loss account, this is going to be shown in the second half of the account.

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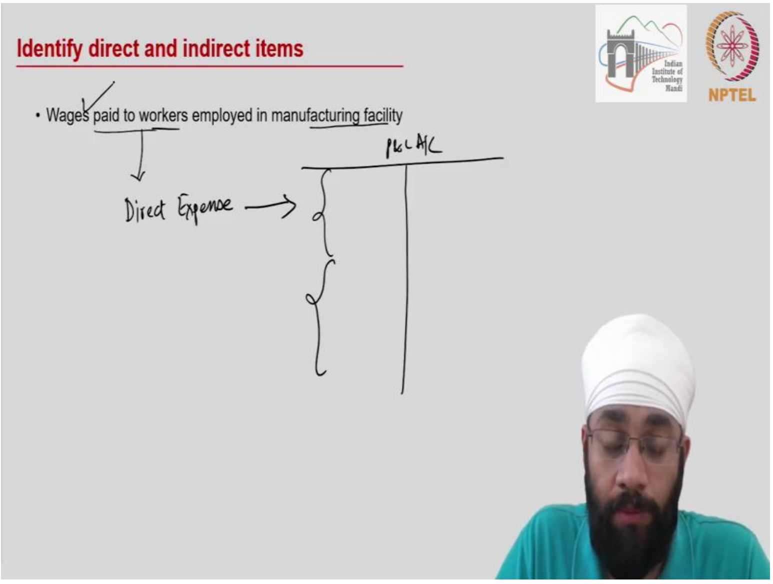

Next up we have wages paid to workers employed in manufacturing facility. Now, here you have a manufacturing plant, for example, and there is a lot of labour working there. So, the wages being paid are directly contributing towards manufacturing the product, towards getting the product ready to be sold. Therefore, this is going to be categorized as a direct expense. It directly contributes to the cost of the product. So, in the profit and loss account; in the profit and loss account this is going to be shown in the first section. The wages paid to workers directly contribute to the cost of the product.

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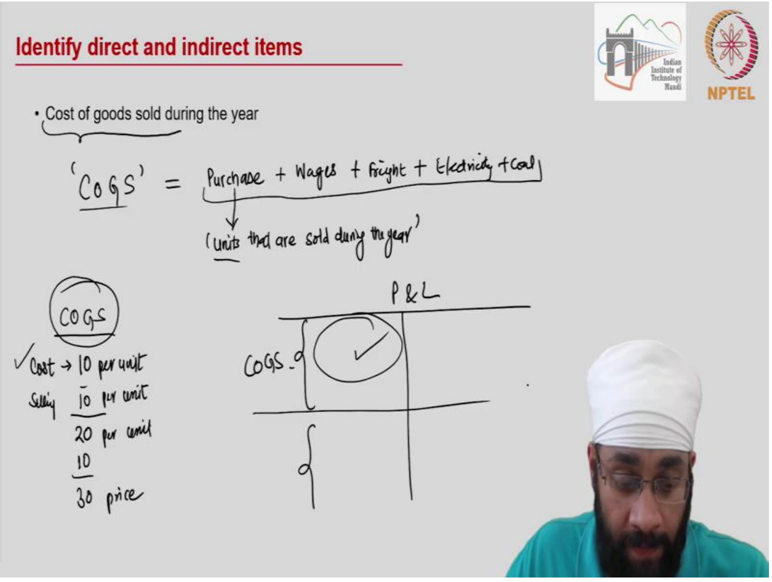

The next item of expenses is the cost of the goods sold during the year. Now, cost of the goods is a specific, well-defined concept of accounting. It is called COGS or COGS, more popularly. Cost of Goods Sold refers to the purchase price. The purchase price of all the goods which are being sold, and then you add to it any other expenses which are being incurred on getting the goods ready to be a finished product. Wages, any freight transportation that is paid, any electricity charges, power, electricity, coal, whatever, all the expenses that are incurred at the factory level are added up here. This is called the cost of the goods, which are being sold. Now, one important point to notice here is that we have discussed this earlier as well. The purchase should include the units that are actually sold: that are sold during the year, because the unsold the cost of unsold goods is an asset to us, that becomes a stock item. The purchase amount here should only include the number of units of the goods available, multiplied by the price at which these were bought and the units should be only the one which are sold, not the total purchases during the year. That is important to be understood. This is the cost of the goods which are being sold in the profit and loss account. This is going to be shown here: cost of goods sold in the first section. In fact, the whole first section is drawn, created, in order to figure out the cost of goods sold. Wherever you are doing a business, the financial strategy is you first of all say, what is it going to cost me to build the product to begin with. It is going to cost me 10 rupees per unit. So, 10 rupees per unit is the cost. Even if I am not thinking about the customer, I am not thinking about retail outlets, advertisement, selling, hiring people, no. Only to manufacture the product I will have to spend 10 rupees per unit. At what price am I going to be able to sell this? This is another decision that you take, another strategic decision that you have to take. And, the way to do that is to think that in order to sell these goods, what is the money that will have to be spent on hiring the sales force, on advertising, on having an office in the centre of the market? So, all those expenses are going to add up and increase the cost. Let us say another 10 rupee is added to the cost of the product and then you would say these are the selling expenses. Selling expenses are going to be 10 rupees per unit as well and then the total cost of the product, this is the total cost of the product which is 20 per unit. Now, how much profit do you intend to make? The simplest way to do that is: well, I would like to have a 50 percent margin. If you want a 50 percent margin, then 50 percent of this is 10, so 30 rupees is going to be my price. So, that is how the price is going to be determined. COGS have a very important role to play in accounting as we move forward. So, just be mindful of what it means. The whole first section has been created to figure out the cost of goods which are to be sold.

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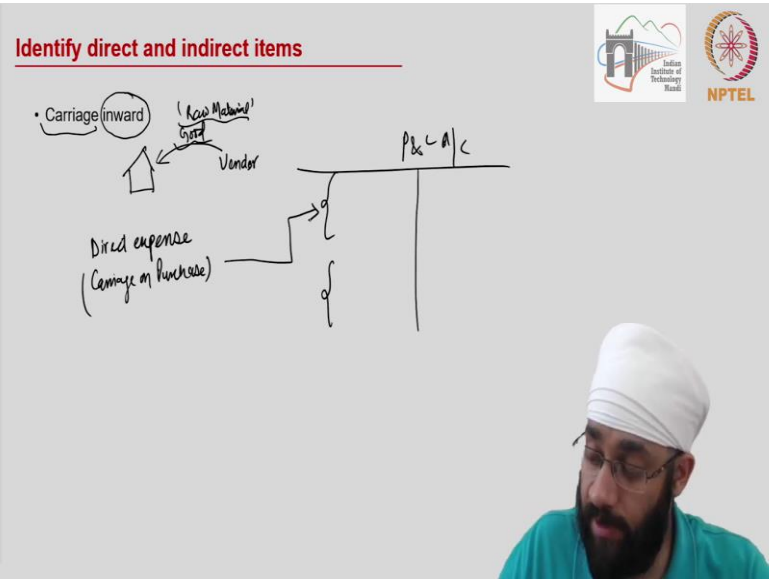

Next item is carriage inward. Carriage is transportation cost, inward refers to the direction of the goods. Now, goods are coming into the business; coming into the business means there is a vendor who is supplying goods and you are paying transportation costs. When you are purchasing things from your vendor this means these are raw materials, and these may very well be finished products as well, but the idea is that these are not expenses related to sales. These are expenses related to getting the product ready for resale. Therefore, this is a direct expense. This is carriage on purchase of the goods or the raw material. So, in the profit and loss account this is going to be shown in the first section, in the direct expenses, in the cost of goods sold.

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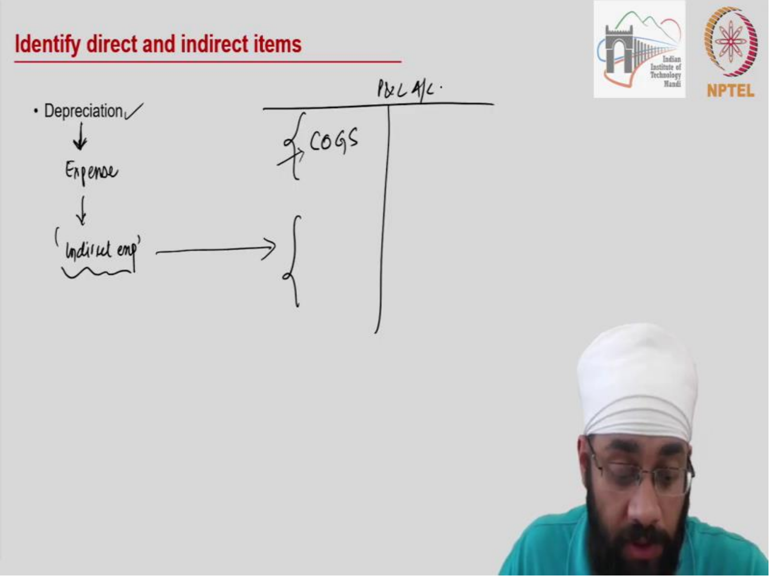

Next item is depreciation. Depreciation is recognized as an operating expense of the business. It is an expense. However, this is not directly related to the cost. It does not contribute directly to the cost of manufacturing of the product, although plant machinery would be used in the process of manufacturing the goods, but the company law, the act, various regulations, categorize depreciation as an indirect expense. It is an indirect expense. Particularly because it is a non-cash expense, you are not actually paying this amount to anybody. So, the idea of having the two sections in the profit and loss account is to first figure out what the cost of goods sold is. Now, this cost you are not paying depreciation to anybody, so you do not want any non-cash items lying around here. So, typically depreciation is going to be considered as an indirect expense, and will be shown in the second half of the income statement or profit & loss account.

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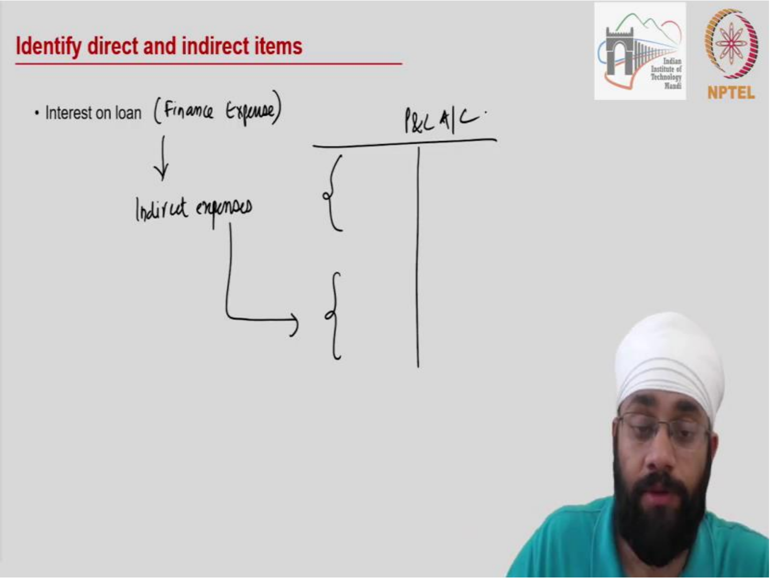

Then, we have interest on the loan. Any expenses on loan are going to be categorized as finance expenses. And clearly, this is nothing related to manufacturing, but raising of loan. This is an indirect expense. All indirect expenses are going to be shown in the second half of the profit and loss account.

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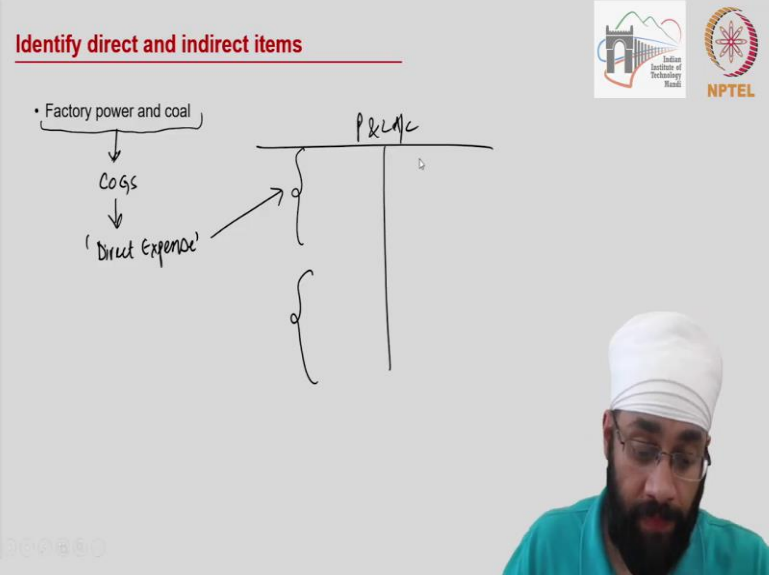

Next is factory power and coal, and I am making these very obvious for you: whenever it is related to factory, it is contributing to the cost of the goods which we want to sell during the year. This is directly contributing to the cost of the product which is being manufactured. Therefore, this is going to be shown in the first half of the profit and loss account.

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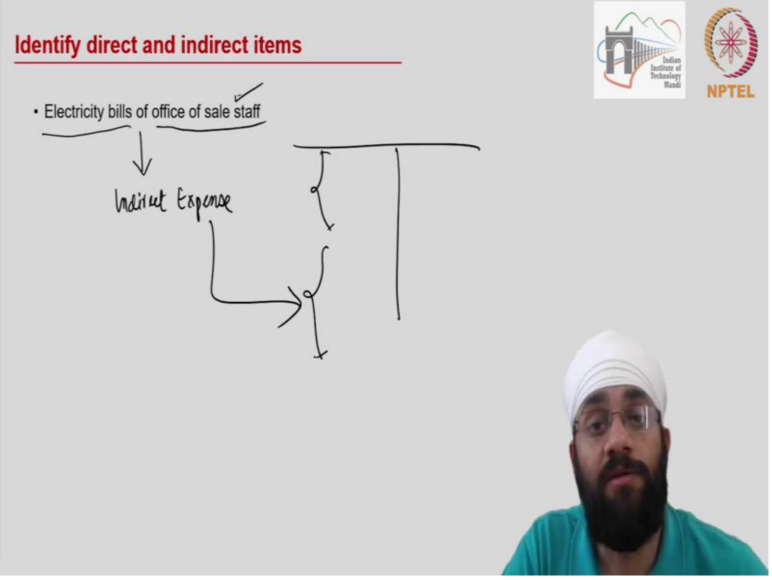

Then, you have electricity bills of the office of sales staff. Again, very specifically it is mentioning that this is an office for sales staff. This is not the office of the factory supervisor. If it was a factory supervisor then the salary is paid to a factory supervisor and all the expenses in the factory form part of the cost of goods sold. Factory expenses can have the same names as well. You may have the rent of the sales office, the rent of the manufacturing supervisor's office. Electricity bill of sales staff, electricity bill of the factory outlet. So, as long as the expenses are related to manufacturing you categorize them as direct. Here this is relating to sales therefore, this is going to be an indirect expense. And hence, in the profit and loss account you will show this in the second half. And these are brackets by the way, hope that is clear. That is it.

These were all the items. These were all the expenses that I wanted to look at. There can be more names, more expenses as well, but the underlying principle, the qualifying criteria is whether or not an expense is contributing to the manufacturing cost of the goods. If it is, it is a direct expense, if it is relating to post manufacturing, to selling and administration, then it is going to be called an indirect expense.

I will see you in the next video.