Series: Basic Cost Concepts

Understanding the Difference Between Product and Period Costs

Transcript

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Introduction

Accountants classify costs according to when they are recognized in the financial statements. There are two cost terms associated with this classification: **product costs** and **period costs**. In this presentation we will explain the nature of product and period costs, provide examples of each type of cost, identify when and how these costs are recognized in the financial statements, and discuss their importance for ensuring the accuracy of financial reporting.

Product Costs

Product costs are all costs assigned to items that are manufactured or purchased for resale. These costs are also known as **inventoriable costs**. In manufacturing companies, product costs typically include all materials, labor, and overhead costs incurred to manufacture a product. Materials costs may also include transportation and handling costs, such as in-bound freight, duties, and in-transit insurance, among others. In merchandising companies, product costs usually include the cost of the goods purchased for resale and any additional transportation and handling costs.

Product costs are reported as inventory on the balance sheet until sold. When an item is sold, its costs are removed from inventory and recorded as an expense on the income statement. This expense is commonly called cost of goods sold, cost of sales, cost of goods purchased for resale, or the cost of merchandise sold, among others.

Period Costs

Period costs are recognized as an expense in the period incurred because they are not expected to benefit future periods. Some examples of period costs include sales and marketing costs, research and development costs, and general and administrative costs. These costs cannot be inventoried and are expensed to the income statement in the period incurred. In service-sector companies, there are usually no inventoriable costs. All costs are considered period costs and expensed immediately to the income statement in the period incurred.

Why the Classification of Product and Period Costs Is Important

The classification of product or period costs is important to ensure the accuracy of financial reporting. Product costs that are incorrectly classified as period costs will lower profitability for a particular reporting period and understate the value of inventory on the balance sheet. Period costs that are incorrectly classified as product costs will increase the profitability for a particular reporting period and overstate the value of inventory on the balance sheet. In either situation, the financial statements are inaccurate because costs have been expensed in the wrong accounting period, affecting both the income statement and the balance sheet.

Non-financial users usually do not control how product and period costs are classified in their organization. However, this knowledge can help them understand how their actions will be reflected in the financial statements for a particular accounting period. For example, savings in product costs may or may not have an immediate effect on improving profitability, depending on how fast the company sells its inventory. However any reduction in period costs will produce an immediate increase in profits.

Summary

In summary, product and period costs describe when costs are recognized as expenses in the income statement. Product costs are recorded as an asset on the balance sheet until sold. Period costs are recognized as an expense in the period incurred. The proper classification of product and period costs ensures the accuracy of the financial reporting in an accounting period and the comparability of financial statements from one period to another. This concludes our presentation on product and period costs. We encourage you to visit our website for more information and additional learning resources.

Glossary of Key Terms

Inventoriable costs. Another term used to describe product costs.

Product costs. All costs assigned to items that are manufactured or purchased for resale. These costs recorded as an asset on the balance sheet until sold.

Period costs. Costs that are recognized as an expense in the period incurred and are not expected to benefit future periods. These costs cannot be inventoried and are expensed to the income statement.