BUSINESS FINANCE

UNDERSTANDING COST OF GOODS SOLD (COGS) FOR BETTER FINANCIAL CLARITY

Cost of Goods Sold (COGS) is one of the most fundamental yet misunderstood concepts in business finance. During a recent conversation with a business owner, the topic of COGS came up, revealing some common misconceptions. To address this, it's crucial to break down the concept, highlight its role in financial management, and explain how accurate tracking can lead to better profitability.

TYPES OF BUSINESSES AND HOW THEY RELATE TO COGS

At a high level, businesses can be classified into two categories:

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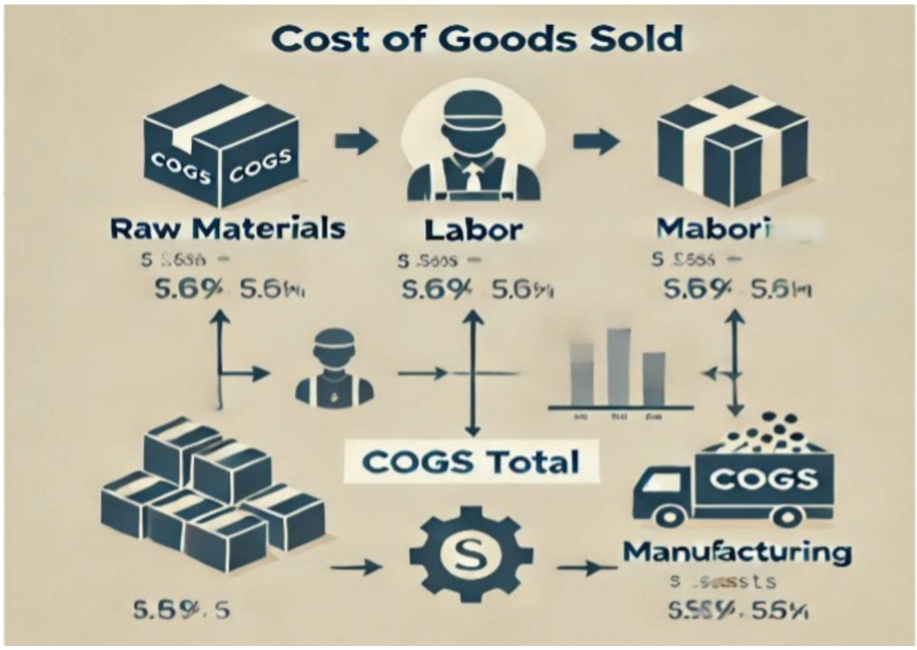
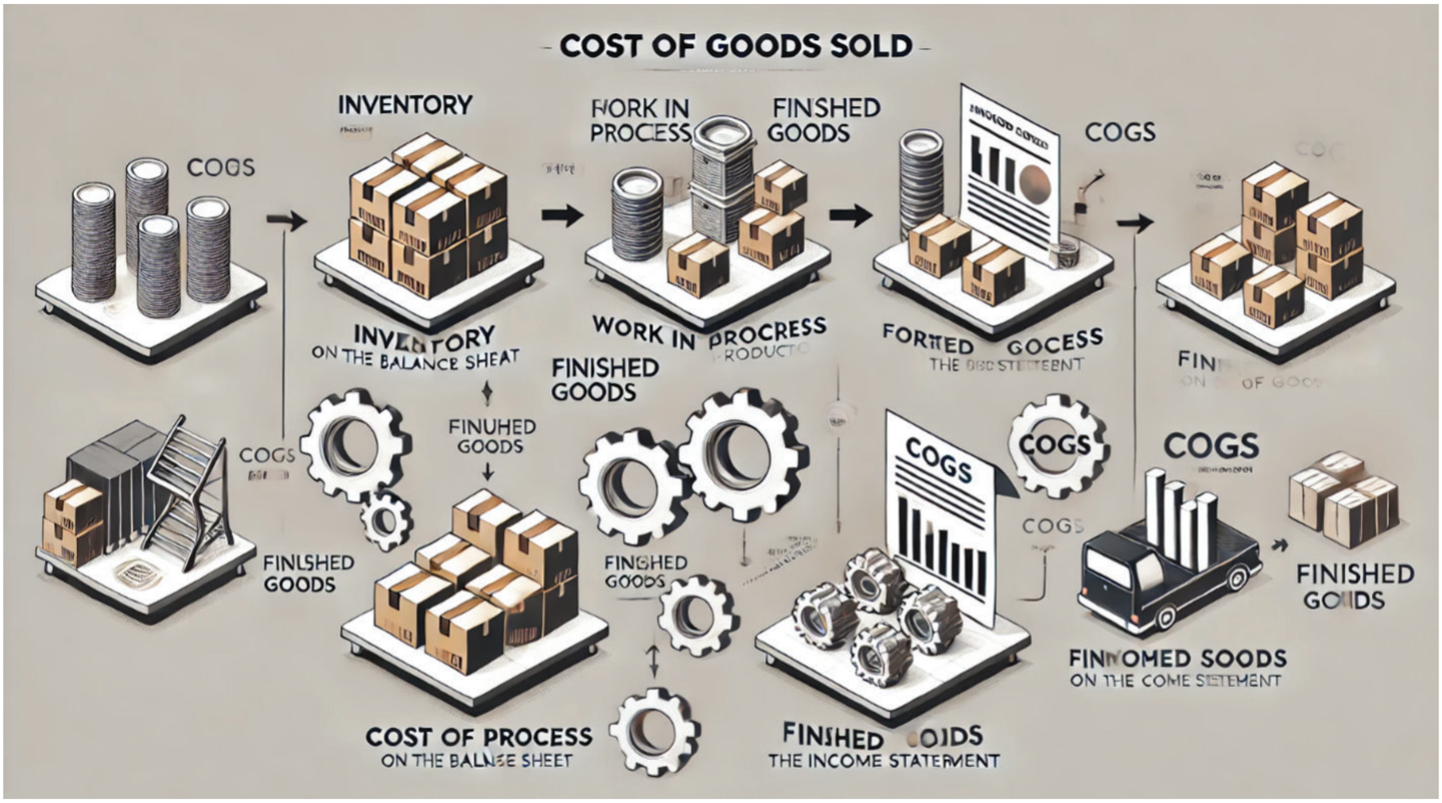


1. **Product-Based Businesses**
   These businesses sell tangible goods, such as electronics, clothing, or machinery. For example, a computer manufacturer purchases parts like processors, screens, and hard drives, assembles them into finished products, and sells them. This process, often referred to as "kitting," combines raw materials into a sellable item.
2. **Service-Based Businesses**
   These businesses sell time and expertise, such as consulting, legal services, or marketing. While they don't have physical inventory, service businesses also have costs directly tied to delivering their services, such as salaries for billable employees or contractors.

THE ROLE OF COGS IN YOUR BUSINESS

COGS represents the direct costs incurred in producing goods or delivering services. For product-based businesses, this includes raw materials, labor, and any overhead tied to the production process. For service businesses, it typically includes the salaries of employees who directly deliver the service.

One misconception I encountered during a discussion with a business owner revolved around their income statement. They noticed fluctuations in overhead costs due to seasonal staffing. However, upon closer examination, these staffing costs should have been categorized as part of COGS. Misclassifying such expenses can distort financial reporting and profitability metrics.



THE ACCOUNTING FLOW OF COGS

To fully understand COGS, it's essential to grasp how inventory and production costs flow through your financial statements:

1. **Inventory on the Balance Sheet**
   Raw materials purchased for production are initially recorded as inventory on the Balance Sheet.
2. **Work in Process (WIP)**
   When production begins, inventory costs move to a subcategory called Work in Process (WIP). This includes labor and overhead costs incurred during production.
3. **Finished Goods**
   Once the production process is complete, the costs move to Finished Goods, still classified as inventory on the Balance Sheet.
4. **Cost of Goods Sold (COGS)**
   When a product is sold and leaves the facility, the associated costs are transferred from Finished Goods inventory to COGS on the Income Statement.

Accurately tracking this flow ensures that only the costs of sold items appear as expenses, helping you calculate true profit margins.

DETERMINING PROFIT MARGINS

Profit margin is calculated as Sales Revenue minus COGS. For example, if you sell a product for $100 and your COGS is $60, your profit margin is $40—or 40%. Showing profit margin as both a dollar amount and a percentage helps you assess performance across periods or products.

WHY PROPER COGS MANAGEMENT MATTERS

Accurate categorization of costs ensures that your financial statements reflect the true profitability of your business. Misclassified costs can lead to inflated overhead expenses and distorted profit margins. For seasonal businesses or those with fluctuating production, this is especially critical.

EXAMPLES FOR BUSINESS OWNERS

Consider a manufacturing business with variable material costs due to market fluctuations. If these variations are captured in COGS, the company can adjust pricing or sourcing strategies to maintain healthy margins.

For service businesses, if labor costs for a specific project are misclassified as operating expenses instead of COGS, the profitability of that project could appear artificially high or low, leading to misguided decision-making.

TAKING THE NEXT STEP

Understanding and managing COGS is not just about accounting; it's about gaining clarity on your business's operational efficiency and profitability. If this discussion has sparked questions or curiosity, let's connect. I'd love to help you dive deeper into your financials and explore strategies to optimize profitability.

Jeff Solomon is the founder and owner of CFO On The Go, a fractional CFO practice. CFO On The Go provides affordable, part-time CFO services to multiple companies allowing business owners and decision makers access to high level, financial leadership.