The definition and application of 'expenses' in accounting - Foundation level

An expense in accounting is the money spent or cost incurred in an entity's efforts to generate revenue. Expenses represent the cost of doing business where doing business is the sum total of the activities directed towards making a profit.

Background to 'expenses' in accounting.

Before reading this Knol it may be best if you first understand and link to the Knol about the difference between a 'cost' and 'expense'. As you will see in that link, 'cost' and 'expense' in accounting have different meanings. i.e. while 'cost' is a monetary measure of the resources we have sacrificed to acquire an asset, an expense is that part of the cost that has expired and been used up by activities directed at generating revenue. So while all expenses are costs, not all costs are expenses.

Expenses take the form of actual cash payments (such as wages and salaries, rent, advertising), an expired portion of an asset (i.e. calculated depreciation/amortization), or a reduction in revenue (such as bad debts). Expenses are summarized and included in the income statement as deductions from the revenue. Revenue minus expenses calculates the net profit for the business for a given period. Note: Cash payments do not always mean that an expense has occurred. For example, a business might pay $10,000 to the bank to reduce its bank loan. This payment will reduce the cash holding of the business but it is not an expense. It is rather a reduction in the amount of the loan and liability the business has to the bank.

In double-entry bookkeeping, expenses are one of the five key account groups where financial transactions can be categorized. The other four are assets, liabilities, owners equity and revenue. Expenses, under the double-entry bookkeeping system debit/credit rules, are recorded as a debit to the specific expense account. A corresponding credit entry will either a decrease in an asset (exhausting something of economic value - usually cash) or an increase a liability (creating an obligation to pay for goods or services used in the generation of revenue - usually accounts payable). Note: The
purchase of such things as vehicles, equipment or building is not an expense. These purchases are known as capital expenditure items and are treated initially as an asset to be expensed over its useful life (i.e. by depreciation/amortization).

Expenses in cash and accrual accounting
Expenses are recorded in the 'books of a business' according to the method/basis of accounting chosen by the business: Cash accounting and accrual accounting (also called cash-basis and accrual-basis). Under accrual accounting the expense will be recorded in the accounting system at the point when a legal obligation has been created. This is usually at the date of goods shipped/received or date that services was performed. Under cash accounting, the recording of the expense is delayed until the actual cash payment is made. (e.g. an electricity bill for the month of April but paid in May will be recorded as Electricity Expense in April under accrual accounting but recorded as Electricity Expense in May under cash accounting).

Accrual accounting is built on the matching principle in accounting. The matching principle endeavors to accurately report the profits for each accounting period. This requires matching the revenue for a given period directly with the expenses incurred in earning that revenue in the same period. For example, under accrual accounting, sales commissions expense will appear on the income statement in the same period that the related sales are reported, regardless of when the commission is actually paid.

Expenses and tax law

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Tax law also has influence in determining the type and amount of expenses that can be claimed as a deduction when determining the income tax payable for a business. For example, while legal expenses may be paid by a business not all legal expenses are deductible expenses under tax law. There are many other examples of business related expenses that may not qualify under tax law as deductible expenses. Accountants and tax agents usually have the job of sifting through the business expenses to remove the unclaimable expenses, prior to the lodgment of your tax returns or reports.

While each country sets their own tax laws, there are some common elements that deal with the issue of "Which expenses qualify as a tax deduction". Common elements include the fact that the expenses must be:

1. part of the ordinary course of doing business
2. necessary for the development of the business
3. paid or incurred during the taxable year
4. not paid prior to the start of a business or in creating it (these would be treated as capital expenditure costs)
5. be a trade or business activity that is continuous, regular and where profit is the primary motive.