

FINANCIAL FOUNDATIONS

An Educational Ebook Series for Small Business Owners

BOOK 06

Cost of Goods Sold (COGS)

Know what your products and services really cost to deliver.



TLC Business Solutions · Expert Bookkeeping & Accounting Services

Cost of Goods Sold (COGS)

FINANCIAL FOUNDATIONS SERIES

CHAPTER 7

Cost of Goods Sold (COGS)

What It Is and Why It Matters — a practical guide to understanding, calculating, and leveraging COGS for a healthier bottom line.



TLC Business Solutions

ACCOUNTING · BOOKKEEPING · TAX · CONSULTING

Cost of Goods Sold (COGS)

IN THIS CHAPTER

Table of Contents

01	What Is COGS?	3
	A clear definition of Cost of Goods Sold and what it represents on your income statement.	
02	How COGS Differs from Other Expenses	3
	Understanding the critical distinction between direct and indirect costs.	
03	How to Calculate COGS	5
	The fundamental formula with a worked example you can follow.	
04	What's Included in COGS?	7
	Materials, labor, and overhead — the three pillars of production cost.	
05	Impact on Gross Profit and Taxes	8
	How COGS shapes your profitability metrics and your tax bill.	
06	Common COGS Mistakes	10
	Six errors business owners make — and how to avoid each one.	
07	Key Takeaways	12
	The essential points to remember and put into practice.	

Cost of Goods Sold (COGS)

GETTING STARTED

Understanding Cost of Goods Sold

If you sell a product, every sale carries a hidden price tag: the cost of what it took to make that product available. That price tag is called **Cost of Goods Sold**, and mastering it is one of the most powerful steps a small business owner can take toward real financial clarity.

1. What Is COGS?

Cost of Goods Sold (COGS) represents the direct costs of producing the goods or services your business sells during a given period. In simple terms, it is the cost of everything that went into creating the products you actually sold — not the products still sitting on your shelf, and not the costs of running your office.

COGS appears on your **income statement** as the very first deduction from your revenue. The result of subtracting COGS from revenue is your **gross profit**, the money left over after you've paid for the goods themselves. Because COGS sits at the top of your income statement, it is sometimes called the "cost of sales" or "cost of revenue."

Understanding COGS matters because it answers a question every business owner should be able to answer immediately: *How much does it actually cost me to produce what I sell?* Without an accurate COGS figure, you cannot know whether your pricing is sustainable, whether your production process is efficient, or whether your business is truly profitable at its core.

2. How COGS Differs from Other Expenses

Not all expenses are created equal. The key to understanding COGS is recognizing that it is a **direct cost** — it moves in lockstep with your sales. Sell more products, and your COGS goes up because you used more materials and labor to produce them. Sell fewer, and your COGS falls accordingly.

Operating expenses (OpEx), by contrast, are **indirect costs**. These are the expenses you pay simply to keep the doors open — office rent, marketing, administrative salaries, insurance, and office supplies. You owe these costs whether you sell ten units or ten thousand. They do not vary with each unit you produce.

Cost of Goods Sold (COGS)

THE DISTINCTION IN ONE SENTENCE

COGS is the cost of *making* what you sell. **Operating expenses** are the cost of *running* the business that sells it. COGS rises and falls with production; OpEx stays relatively fixed regardless of output.

This separation is not just an accounting technicality — it reveals something vital about your business. By isolating COGS from operating expenses, you can calculate **gross profit** (Revenue – COGS) independently of your overhead. That tells you whether your *core product* is profitable before you've paid a single office bill. If your gross profit is thin or negative, no amount of cost-cutting in the back office will save you — the problem is in how you produce and price your goods.

Cost of Goods Sold (COGS)

THE MATH

Calculating COGS

3. How to Calculate COGS

The good news is that the COGS formula is straightforward. It relies on three numbers you can pull from your inventory records and purchase logs:

THE COGS FORMULA

$$\text{COGS} = \text{Beginning Inventory} + \text{Purchases} - \text{Ending Inventory}$$

Here is what each piece means:

Beginning Inventory is the value of the inventory you had on hand at the start of the accounting period. **Purchases** is the total cost of any additional inventory or materials you bought during that period. **Ending Inventory** is the value of what was still on your shelves at the end of the period — the goods you did *not* sell.

The logic is simple: you start with what you had, add what you bought, and subtract what's left. Whatever remains is what you sold — and that is your Cost of Goods Sold.

WORKED EXAMPLE: A BAKERY

A bakery begins the month with **\$2,000** worth of ingredients in stock.

During the month, it purchases **\$5,000** in additional ingredients.

At month's end, **\$1,000** in ingredients remains on the shelves.

$$\text{COGS} = \$2,000 + \$5,000 - \$1,000 = \$6,000$$

In this example, \$6,000 represents the cost of the ingredients that actually went into the baked goods the bakery sold that month. If the bakery brought in \$10,000 in revenue, subtracting the \$6,000 COGS leaves a **gross profit of \$4,000** — and a gross profit margin of 40%. That margin is the efficiency engine of the business.

Cost of Goods Sold (COGS)

WHY ACCURACY MATTERS HERE

This formula is only as reliable as the numbers you feed it. A miscounted ending inventory, a forgotten purchase, or an outdated beginning balance will distort your COGS — and from there, every downstream metric (gross profit, margins, even your tax bill) will be wrong. Consistent, accurate inventory tracking is the foundation on which COGS is built.

Cost of Goods Sold (COGS)

THE COMPONENTS

What's Included in COGS?

4. What's Included in COGS?

COGS captures three categories of cost, all of which must be **directly tied to the production of your goods**. If a cost cannot be traced to the act of making your product, it does not belong in COGS — it belongs in operating expenses.

M

Direct Materials

The raw materials and components that physically become part of your finished product. For a bakery, that's flour, sugar, and butter; for a furniture maker, wood, screws, and finish.

L

Direct Labor

The wages and benefits paid to employees who work directly on manufacturing your product — the bakers, the assembly-line workers, the craftspeople whose hands make the goods.

O

Manufacturing Overhead

Indirect production costs such as factory rent, equipment depreciation, utilities for the production facility, and supervisory wages — costs that support production but aren't a single unit.

WHAT DOES NOT BELONG IN COGS

Office rent, marketing and advertising, administrative salaries, sales commissions, software subscriptions, and general office supplies are all **operating expenses**, not COGS. A simple test: *Did this cost help create the physical product you sold?* If yes, it's COGS. If it helped run or sell for the business, it's OpEx.

For **service-based businesses**, the concept adapts. If you run a consulting firm, your COGS might include the wages of the consultants who deliver billable work and any software or materials used directly in serving clients. The principle is the same: COGS captures the direct cost of delivering the service you sold, while everything else is overhead.

Getting these classifications right from the start saves you from distorted margins, surprised accountants, and avoidable tax issues down the road. When in doubt, consult a qualified accountant — misclassifying costs is one of the most common — and most expensive — bookkeeping errors small businesses make.

Cost of Goods Sold (COGS)

THE BOTTOM LINE

Impact on Profit & Taxes

5. Impact on Gross Profit and Taxes

COGS does not live in isolation — it directly drives two of the most important numbers in your business: your **gross profit** and your **taxable income**. Understanding both connections is essential for making smart pricing, production, and tax decisions.

Gross Profit is what remains after COGS is subtracted from your revenue. It is the first and most fundamental measure of whether your core business model works:

GROSS PROFIT

Revenue - COGS

The money left after paying for the goods you sold. Your core production profitability.

GROSS PROFIT MARGIN

$(\text{Revenue} - \text{COGS}) \div \text{Revenue} \times 100$

Expresses gross profit as a percentage of sales. The higher the margin, the more efficient your production.

Using our bakery example: with \$10,000 in revenue and \$6,000 in COGS, gross profit is \$4,000 and the gross profit margin is **40%**. That means for every dollar of sales, forty cents survives to cover overhead and, ultimately, profit. Tracking this margin over time — and benchmarking it against industry averages — tells you instantly whether your production costs are creeping up or your pricing needs adjustment.

COGS also has a direct line to your **taxes**. Because COGS is deducted from revenue to determine your **gross profit**, it lowers your **taxable income**. The relationship is straightforward: a higher, accurately-calculated COGS means lower reported profit, which means a lower tax bill. This is not a loophole — it is the tax code working as intended. You are only taxed on profit, and COGS is a legitimate deduction that reflects the true cost of generating your revenue.

THE TAX TRAP WORKS BOTH WAYS

Because COGS reduces taxable income, accuracy cuts both ways. **Understate** your COGS and you'll overstate your profit — paying more tax than you owe. **Overstate** it, and you under-report profit, risking penalties and interest if the IRS catches the error. The goal is never to minimize or maximize COGS; it is to calculate it **correctly**. An accurate COGS protects you on both fronts.

This is why consistent, well-documented inventory tracking matters so much. Every dollar of

Cost of Goods Sold (COGS)

COGS you can legitimately and accurately claim is a dollar of profit you are not over-taxed on. And every dollar you mistakenly leave out is profit the IRS will happily tax you on. Done right, COGS is both a profitability metric and a tax-management tool.

Cost of Goods Sold (COGS)

AVOID THESE PITFALLS

Common COGS Mistakes

6. Mistakes Business Owners Make

COGS is simple in theory but easy to get wrong in practice. Here are six of the most common — and costly — mistakes small business owners make, along with how to avoid each one.

1

Confusing COGS with Operating Expenses

Stuffing office rent, marketing, or admin salaries into COGS inflates your deduction and distorts your gross margin. Keep a clear line: if the cost isn't directly tied to production, it belongs in operating expenses — not COGS.

2

Inaccurate or Infrequent Inventory Counts

Your ending inventory is the linchpin of the COGS formula. If you guess at it or only count once a year, your COGS — and everything it feeds — will be off. Conduct regular, methodical physical counts or use a perpetual inventory system.

3

Forgetting Manufacturing Overhead

Many owners remember materials and labor but overlook indirect production costs like factory utilities, equipment depreciation, and production-supervisor wages. Omitting these understates COGS and overstates your taxable profit.

4

Inconsistent Accounting Methods

Switching between FIFO, LIFO, or weighted-average inventory valuation without consistency makes period-to-period comparisons meaningless and can raise red flags. Choose a method, apply it consistently, and consult your accountant before changing it.

5

Excluding All Direct Labor

Only counting some production wages — say, hourly workers but not the production supervisor, or forgetting benefits and payroll taxes — understates your true cost of goods. Capture the full cost of every employee directly involved in production.

6

Mixing Personal and Business Inventory

Using business inventory for personal purposes — or vice versa — corrupts your counts and your COGS. Keep personal and business purchases strictly separate, and document any inventory withdrawn for non-business use.

Cost of Goods Sold (COGS)

THE COMMON THREAD

Every one of these mistakes stems from the same root cause: **imprecise categorization and record-keeping**. The fix is rarely complicated — it's a matter of consistent processes, regular inventory counts, and a clear understanding of what belongs where. When in doubt, a qualified accountant can set up your chart of accounts correctly so the right costs flow to the right place automatically.

Cost of Goods Sold (COGS)

REMEMBER THESE

Key Takeaways



COGS Is Your Direct Production Cost

COGS captures only the costs directly tied to producing what you sold — materials, direct labor, and manufacturing overhead. It is the first and most fundamental deduction from your revenue.



COGS Moves with Sales; OpEx Doesn't

COGS is a direct cost that rises and falls with production. Operating expenses are indirect costs you pay regardless of output. Keeping them separate is what lets you measure true production profitability.



The Formula Is Simple: Beginning + Purchases - Ending

Start with what you had, add what you bought, subtract what's left. What remains is the cost of what you sold. Accuracy depends entirely on reliable inventory counts.



COGS Drives Gross Profit and Your Tax Bill

Revenue minus COGS equals gross profit. Because COGS reduces taxable income, calculating it accurately protects you from both overpaying taxes and under-reporting profit to the IRS.



Classify Costs Correctly from the Start

Misclassifying operating expenses as COGS (or vice versa) distorts your margins and your taxes. When in doubt, ask: did this cost help create the product? If yes, it's COGS.



Accuracy Is Everything

Regular inventory counts, consistent accounting methods, and complete cost capture are the foundation of a trustworthy COGS figure. The effort you put in here pays off in cleaner books and smarter decisions.

Cost of Goods Sold (COGS)

Need Help Getting Your COGS Right?

At TLC Business Solutions, we help small business owners build accurate, reliable accounting systems — from inventory tracking to financial statements to tax strategy. With over 30 years of experience and our predictable flat-rate billing model, you get expert support without the anxiety of hourly invoices.

• TLC Business Solutions · Ukiah, California · 916.596.0803 · tlcbusinesssolutions.com



Build Your Financial Foundations with TLC

TLC Business Solutions helps small business owners strengthen bookkeeping, accounting, payroll, tax consulting, financial management, and practical decision-making systems so the numbers are clean, useful, and ready for growth.

tlcbusinesssolutions.com

<https://drive.google.com/drive/folders/1Qpwq3hbcqCLn0JDLNPYmjzHl7-MjROEZ?usp=sharing>

FINANCIAL FOUNDATIONS · BOOK 06 OF 16 · TLC EBOOK SERIES
