CHAPTER - V

THE CONCEPT OF EXPENSE

Among the different methods suggested for dealing with the expenditure for Research and Development in accounting—one important method has been to treat all Research and Development costs as an item of expense as and when these are incurred in accordance with the cash flow concept. In other words, the view is that all Research and Development costs should be charged to expense as and when incurred representing the unfavourable changes in the recourse of the firm. In this context therefore, an attempt is made in this chapter to deal with the concept of expense, so that we can subsequently examine and evaluate the rationale in treating the outflow for Research and Development as an expense.

Definition of an 'Expense':

The term expense has been interpreted in various ways. Receipt of real things representing assets are recorded in accounts by a debit entry assets being considered a store of services to be received in future. On the same logic expenses are also recorded in the account on the debit side. These expenses are called revenue expenses. In support of this proposition we take the instance of payment of wages. In case of payment of wages the payment is made
as consideration for a service received by the business, namely the labour of employees, as such it represents the payment for services received from the employees that have been consumed instantaneously. In a good number of cases, if not in all, it is not difficult to show that expenses are associated with the receipt of some kind of service or benefit in one form or other though it is not unlikely to have some expenses which do not appear to remain associated with the receipt of any service or benefit. Instances on the point are expenses like payment of charity, gift, rates and taxes and bad debts that arise from the failure of the debtors to pay their debts. Nevertheless the payment for these and the loss arising from bad debts are recognised as transaction and treated as such in the measurement of business income. In recording an expense a similarity is always drawn between goods bought and sold for cash or credit and services bought and sold for cash or credit which are consumed instantaneously by the recipient of such services. It may appear paradoxical to treat an expense which usually refers to a loss, arising out of the receipt of something whatever it might be. But by going deeper into the problem it would becomes crystal clear that behind an expense there must be a transaction and the same should consist of receipt of something having a value in


exchange. Otherwise, no value would have been spent in return nor any entry made for making a record. If it is proved that services are competent enough to possess this value in exchange and their receipts make rightful transactions there would be nothing more to complain. While receipts of services are found to amount to some independent events occurring automatically without having any bearing upon accounting records or if they are such as can by no means be treated as transactions, one cannot but search for what else the receipts under expense transactions may really happen to comprise.

From what has already been stated it transpired that expenses in general are payment for receipt of services that are consumed instantaneously. It now therefore remains to examine the nature of the sources of such services.

Nature and Sources of Services

Treated as Expense:

It cannot perhaps be disputed that consumption of material things becomes an important source of receipt of services. In case of making the case for considering investment in material things or assets as the price paid for a series of future services, one view has been that as each portion of the total service is obtained from an asset or investment an appropriate amount out of the asset or total investment may logically be presumed as representing the cost of the service from the asset or investment that has been
consumed in the operation of the business and charged accordingly as operational expense. It is in this sense depreciation is considered as an expense. It has however to be remembered in this connection that assets depreciate not only for being used or rendering services alone. Assets depreciate also due to loss in value of the asset out of 'natural elements' or passage of time. Now the question is can such depreciation be treated as equivalent to receipt of proportionate value of service from an asset or investment that are charged as expense for the operation of the business. One way to avoid the controversy would be to accept the proposition that the proportionate service received from an asset or investment and charged to operation represents the value of the asset lost due not only to rendering of services exclusively but also due to other causes as well that may be inforce during the period of the expected life of the assets. Even then the problem that would remain unresolved is the case of depreciation during idle time or due to obsolescence covers an accounting period as a whole.

Similarly writing off of bad debts is another instance on the point how without rendering any service an asset may be deprived of its value. If there may be depreciation without rendering of services in return, there may be receipt of services without depreciation. When it is found that the value

of free-hold property in land is not wasted in course of earning revenue it has been suggested that the free-hold property in land as an asset is to be shown at cost in the balance sheet. It would therefore be observed that though the amount of service obtained from free-hold property as an asset is not small it is not depreciated. Therefore, depreciation is or is not recorded irrespective of whether there is any corresponding receipt of service. In case of recording depreciation what is solely recognised and given effect to, is the 'effect' that is the loss in value of the asset and not the cause because anything may be the cause of depreciation. It is in this sense depreciation is the inherent wastage in the value of an asset due to any cause. So the debit entry to an expense account that follows accounting of depreciation does not stand for receipt of services. With this in backdrop it becomes crystal clear that yielding of service by material things may in several cases occur in reality as an independent event much to the advantage of the business. But its receipt is not treated as a recordable transaction. As a result it does not stand to reason why services obtained from other sources should be treated in various way. The idea of treating receipt of services a transaction, it seems, has been borrowed from the Science of Economics. In Science of Economics Economic goods or Wealth is said to consist of tangible goods as well as services. Apart from there being a fundamental difference in physical existence, goods and services do not seem to resemble each other very closely as subjects of

5. Ibid.
exchange in other respects too. However, goods are not purchased solely for the sake of themselves. Only possession of goods serves no purpose unless some benefits are derived from the goods. It is for the enjoyment of these benefits that goods are actually purchased. Goods in the shape of scrap or stock in trade may have only a value in exchange to the seller. Nevertheless, the value in exchange itself actually comes to exist on account of the utilities and the utilities are expected to be derived by the ultimate purchaser who is due at last to consume these goods. In this situation goods are considered by such a buyer like a fund, store or source of some benefits which is worth being acquired in exchange for a value. Again there is a doubt for considering services as a store of benefits in the same sense. Services are, rather, benefits themselves. Thus, what might reasonably be at par with goods as subject matter of exchange is not service itself but a suitable source from which services may flow. Further, goods or material things do not entitle one to the benefits to be obtained from them, rather the bundle of rights i.e., right to enjoy; right to possess, right to sell etc. that together constitute ownership in them. Goods can be looked upon as the physical embodiment of these rights. Similarly it is argued that the source of services of non-material or human origin is also a right or claim to such services. Therefore, as exchangeable value, goods should mean right to some benefits and, as such, goods should be equivalent to, not services of non-material or human origin but rights or claims to such services. Receipt of real things means
an event which is quite distinct and separate from the actual enjoyment of benefits from them. In this respect it is considered as a receipt of value which, if necessary can be sold out subsequently. Though ability to yield benefits is an additional advantage attached to them, the receipt of exchangeable value becomes an important part from the point of view of accounting. In case of real accounts a debit entry means gain of real things as exchangeable value and a debit balance in such accounts, except the portion that eaten up meanwhile by depreciation or otherwise, represents possession of them as such a value\(^7\). On the other hand to conceive of receipt of service appears to be rather unreasonable. In reality services are received only through the very process of their enjoyment. And between receipt and enjoyment services retain, unlike real things, no exchangeable value of any amount. Since the labour of employees is received as services according to Spicer & Pegler the debit entry to the Wages Account represents that type of service. But the opinion given by Spicer & Pegler is to some extent not very clear and specific because it does not certainly indicate in what aspect services are being represented by the entry. Even on the bases of what is received being services it is unable to represent an expired value which presupposes a prior existence of the value.

It is argued that through enjoyment of benefits the two separate stages of receipt of exchangeable value and the

\(^7\) G.D. Roy, *op.cit.*, p.104.
subsequent loss of that value must exist in case of services as well. But these two coincide with each other so accurately or occur so simultaneously that the stage of expired value is at once arrived at without there being any opportunity for a tangible existence of the exchangeable value stage, all by itself for even a single moment. In case of economic services the value is expended as soon as the service is received. Telephone, light and salaries accounts are the examples of such economic services. Like tangible commodities namely merchandise or equipment these economic services cannot be accumulated or stocked. Therefore, if the exchangeable value is connected to services the receipt of such services is only theoretical and these cannot be accumulated. Not only that, even a transfer of the value after being received is not possible. Thus the exchangeable value should be attached to a 'right to service' so that by virtue of the right or ability acquired before the receipt or enjoyment of the service the business can be able to substitute others to tap the same source of service. In this respect like lending the services of an employee how a resale or re-transfer allowing others to use the office telephone at a charge or subletting previously rented premises can, possible be explained. And all these explain sufficiently how others by virtue of a transfer are to be allowed to reap the benefit out of a claim which the business entity was originally entitled to. For the sake of argument even if the transactions are interpreted not as transfer but as rendering of services by the

business at its own instance and out of its own resources by way of sale, it cannot be denied that what are received by way of transaction in this regard are not services but claims to services. In support of this proposition we may consider the instance of a building which is rented for a certain period of time but due to certain reasons or others, the building is not used. Shall not the rent be still required to be paid? Although no service is obtained rent is still paid as it is assumed that what is paid for is not service but for a claim to service. Though the claim to use the building is acquired in exchange for a payment or a promise for payment of money it is the option of the acquirer to exercise the claim or not. Similarly in case of an accidental disorder in machinery no services are received or enjoyed in return but the wages are paid to employees for such period. The payment is only made against receipt of a 'claim to service' which could not be exercised owing to certain problems which were beyond the control of any person.

From what we have discussed so far it is clear that an expense is not always a payment for service received and consumed instantaneously. There are instances when an expense becomes a payment for the maintenance of the claims to services acquired by the owner in the expectation of receiving services in future.

In the perspective of the aforesaid conceptual aspect of expenses it will now be worthwhile to study how an expense is viewed by the accounting bodies and the profession.

9. Ibid.
Expenses in the Views of Accounting Bodies and Profession:

The Accounting Principles Board statement No. 4 issued by the American Institute of Certified Public Accountants dated October 1970 has defined expenses as gross decreases in assets or gross increases in liabilities recognised and measured in conformity with generally accepted accounting principles that result from those types of profit-directed activities of an enterprise that can change owners' equity. This definition of expenses, according to many, is not above criticisms and these criticisms are:

(a) The definition does not clearly specify the meaning of the term 'gross'.

(b) Any kind of decrease in assets or increase in liabilities can change owners' equity, e.g., repayment of loan and gain or loss on retirement of debt. But repayment of loan or all kinds of decrease in assets or increase in liabilities do not necessarily form an expense, though these cause a change in owners' equity.

(c) As with revenues, definition of expense in terms of changes in equity is less than helpful if equity is itself a residual.


A more recent definition of expense can be had in Para 65 of the Financial Accounting Standard Board's Concept Statement No. 3 dated December 1980. This statement defined expenses as "outflows or other using up of assets, or incurrence of liabilities (or a combination of both) during a period from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's ongoing major or central operations." The statement also mentioned that assets used in a manufacturing company may become part of the cost of the product and therefore the using up of assets in this case does not create an expense until the product is sold. For till the product is sold there is practically no consumption of service potential from an asset or no consumption of services received by incurring a liability. But like the definition offered by the Accounting Principles Board the definition of expense enunciated by the Financial Accounting Standard Board has also been subjected to various criticisms. It is pointed out that:

(a) This definition of expense does not make clear the distinction between the monetary and physical events.

(b) Secondly, incurring an expense cause a liability or a decrease in cash, not the other way around.

(c) Thirdly, there are some outflows of assets and incurrences of liabilities which take place during the enterprise's major operations which are not to be treated as expense. For

instance payment of insurance premiums in advance and ex-
change of asset for liability.

Some also objected to the absence of a refer-
ence to Generally Accepted Accounting Principles.

The definition of expenses has been elaborated
by explaining the characteristics of expenses of business enter-
prises in Para 66 of the same statement. According to it expen-
ses represent actual or expected cash outflows (or the equiva-
ient) that have occurred or will eventuate as a result of the
enterprise's on going major or central operations during the
period. The assets that flow out or are used or the liabilities
that are incurred may be of various kinds such as unit of pro-
duct delivered or produced, kilowatt hours of electricity used
to light an office premises or taxes on current income. Similarly,
the transactions and events from which expenses arise and the
expenses themselves are in many forms and are called by various
names such as cost of goods sold, cost of services provided de-
preciation, interest, rent and salaries and wages—depending
upon the expenses are recognised.\(^\text{13}\).

\[\text{Sometimes an expense is referred to as an}
\text{"expired cost" by the accounting bodies and the profession. The}
\text{definition of expense given by a special committee of the American}
\text{Accounting Association in 1957 is an example on the point.}\]

\(^{13}\) L.S. Porwal, op.cit., p.148.
The special committee of the American Accounting Association defined an expense as "the expired cost, directly or indirectly related to a given fiscal period, of the flow of goods or services into the market and of related operations"\textsuperscript{14}.

On the basis of discussions so far made it would be noticed that despite multiplicity of definitions, the concept of what makes an expense is not very clear. What is more interesting is that often the concept developed in respect of an expense by one definition differs from the one developed by the other\textsuperscript{15}. And from these definitions it becomes difficult to accommodate payments made for maintenance of a claim to services as expense unless the same is considered as a natural part of the processes for productive activities. Nevertheless, expense as a concept is recognised and measured. And this recognition of expense and its measurement are now being discussed.

Recognition of Expense

From the discussion so far made it may be said that an expense is incurred when goods or services are consumed or used in the process of obtaining revenue or for maintaining a claim to receive services in future. Recognition of expense is done at the time of recording activity in accounts or after the activity or before the activity in some situations. In the matter of recognition of expense:

\textsuperscript{14} Vernon Kara, op.cit., p.214.

\textsuperscript{15} K.S. Most, op.cit., p.421.
expenses there are certain principles and the principles that are followed are. 

(a) Matching Principle

One principle of expense recognition is the matching principle, matching being the process of reporting expenses on the basis of a cause-and-effect relationship with reported revenues. Matching as a concept has its general as well as specific application. In the general sense, it denotes the process of associating like things together and in its specific sense, it is always understood to mean matching of expenses against revenues. In accounting, revenues are measures of accomplishment of the business firm while expenses are measures of its efforts. Periodic income is the excess of revenue realised over expenses matched. Income of a firm can also be computed on the basis of networth values but income computation via matching is usually preferred because this process yields much more valuable information about the income earning process than what is available under the former. Recognition of expenses through matching process requires first, association of expense with the revenue and secondly, reporting expense in the same period when there is revenue flow. For the purpose of matching some costs are recognised as expenses on the basis of presumed direct association with specific revenue though

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there may be situations where expenses are incurred without corresponding generation of revenues. Such expenses are classified as indirect or period expenses. In case of such expenses benefits are presumed to expire with the passage of time. Such expenses are not allocated directly to products. Instead, the aggregate amount of such expired cost is matched against the total value gained by the firm during the same period\(^\text{19}\).

(b) **Systematic and Rational Allocation**

A second principle for expense recognition is the systematic and rational allocation. Cost is an expenditure or outlay of cash, other property, capital stock, or services, or the incurring of a liability therefor, identified with goods or services purchased or with any loss incurred, and measured by the amount of cash paid or payable or the market value of other property, capital stock, or services given in exchange\(^\text{20}\). The cost for an asset that provides benefit for only one period is recognised as an expense of that period. This is considered as the systematic and rational allocation. But if an asset provides benefit for several periods, its cost is to be allocated over the periods during which services are received from the asset in a systematic and rational manner in the absence of a more direct allocation.

basis for associating cause and effect. The allocation method in the situation has to be reasonable and it has to be used systematically.

(c) Immediate Recognition

Thirdly, if no logical justification exists for the employment of the first principle i.e. matching principle, then the choice is to be either cost allocation as explained earlier under second principle or immediate recognition. Immediate recognition can be viewed as the one that accounts for all other possibilities not covered by the first two. Instance on the use of this principle, that is immediate recognition, is the recording of advertising expenses. The effect of advertising may have long-lasting benefits, but they are difficult to determine. A customer may purchase a product from a company because he was influenced by the advertisement he saw two years ago. Since the benefits cannot be ascertained in a credible manner, the cost of advertising is recognised immediately as an expense.

Measurement of Expense

Income is the excess of inflows on revenue accounts over the outflows on the same accounts including the recovery of the expired costs. Therefore income measurement cannot be accomplished without the measurement of expenses. According to those who define expenses

as decreases in the net assets of the firm, a logical measurement is the value of the goods and services at the time they are used in the operations of the enterprise. On the other hand, those who emphasize the reporting of cash flows of the enterprise usually suggest that expenses should be measured in terms of transactions to which the firm is a party and measured by the past, current or future cash expenditures. In either view of income, the purpose is to measure the amounts assignable to the current period and to defer to future periods those amounts that represent transformations of goods or services to be used in future periods. The most common bases for measurement of expense are:

(a) **Historical Cost**

The traditional method of measuring expenses is in terms of the historical cost to the enterprise. The main reason for adhering to historical costs is that they are assumed to be verifiable, since they represent cash outlays by the firm. It is also claimed that they represent the exchange value of the goods and services at the time they were acquired by the enterprise. One essential feature of this argument is that management considered the value of the goods and services to be at least as great as the cost at the time of acquisition or they would not have been acquired. Again there is no real evidence that the firm would have acquired the goods and services if it had to pay a higher price for them. Therefore, the best evidence available

indicates that they were worth just what they cost the firm, no more or less. The main demerits of historical cost are that it frequently does not represent a relevant measurement of the goods and services used in attempting to meet the objectives of the external users of financial reports, and that it does not permit a separation of operating activity from gains and losses arising from fortuitous purchases or unpredictable price changes. 

(b) Current Replacement Cost 

It is often argued that expenses matched against revenue should be measured in current prices of the goods or services used or consumed. The use of current prices such as the replacement cost, it is said, helps in identifying (i) income arising from the transaction and (ii) gains or losses arising from the holding of assets prior to use. The current replacement cost represents the acquisition price at the time of use and therefore, it may permit a better prediction of the results of the future firm activity.

An expense is an expired cost of an asset. Therefore, when the asset in respect of which the expense arises has a ready market for purchase and sale the measure of expense may be the current liquidation price or the entry price, as a measure of expense, is preferred as it permits a more accurate

prediction of the results of the activity of a firm in future since it is presumed to represent the acquisition price at the time of use. The measurement of expenses on the basis of the current replacement cost at exit or entry price, it is however contended by many has the possibility of having a lot of subjectivity in it especially when there is no ready market for purchase or sale of the asset consumed in respect of which the expense arises and as such there is no scope for verification of the current replacement cost.

(c) **Opportunity Cost**

It is the last of the bases advocated for the measurement of expenses. It is considered as a basis in respect of the expired cost of an asset consumed where the cost for the asset is substantially different from the current market prices. A typical example of such an asset is the inventories (raw materials) consumed for which there is a scarcity and as such the future prices are expected to be substantially different from the current market prices. In a situation of future scarcity the ideal basis for measurement of expenses as expired cost, is the opportunity cost of the asset consumed.

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