COST CONCEPTS

- **Introduction:** A firm carries out business to earn maximum profits. Profits are the revenues collected by a business firm after production and sale of their goods and services. But to gain something, the producer has to lose something. That means, to earn revenues the producer has to incur costs.

- **Cost:** A cost is an expenditure incurred by a firm to produce goods and services for sale in the market. In other words, a cost is the outflow of money from the business to gain inflow of money after sale of the commodity. A producer has to incur various costs in order to produce goods and services. These costs are of various types.

- **Types of cost:** The following are the various types of costs:-
  1. Direct costs or explicit costs
  2. Indirect costs or implicit costs
  3. Fixed costs
  4. Variable costs
  5. Accounting costs
  6. Economic costs
  7. Total costs
  8. Average costs
  9. Marginal costs
  10. Opportunity costs
  11. Operating costs

- **Direct cost or explicit cost:** Explicit costs are those costs which are met by cash payments for employing various factors of production. The producer actually pays money to produce his goods and services. A direct or explicit cost is the material, labor, expenses, overheads, selling and distribution, administrative cost related to production of a commodity. It is accurate in nature. An explicit cost can be easily traceable. An explicit cost is defined as follows:

"An explicit cost is a direct expense that is paid in money to others or creditors during the production of goods."

Uses of explicit costs:

1. It shows the expenditure incurred on production of the commodity which is considered for pricing strategy;
2. It also helps in calculating profits;
3. It helps in decision – making;

- **Indirect cost or implied cost:** Implicit costs are those costs which the firm lets go or sacrifices in order to hire an alternative factor of production. These costs are opportunity costs of the factors of production. Implicit cost is also called as imputed cost. Here cash outflow does not happen. An implicit cost is defined as under:

  "An implicit cost is the factor of production sacrificed by the producer for an alternative factor production. The opportunity foregone is the implicit cost."

Uses of implicit cost:

1. It helps in decision making
2. It helps to ascertain opportunity costs
3. They directly impact profitability of the firm

- **Difference between explicit cost and implicit cost:**

Explicit cost	Implicit cost
1. Meaning: Explicit costs are those costs that are met by cash payments.	Implicit costs are those costs that are not met by cash payments.
2. Nature: It is a direct cost.	It is an indirect cost.
3. Record keeping:	

There is a proper record keeping of these costs as there is money outflow in this.	There is no record for these costs as there is no money outflow involved.
4. Type: It is an expenditure incurred for production.	It is an opportunity sacrificed to employ other factor of production.
5. Money outflow: There is outflow of money.	There is no outflow of money.
6. Other names: Output pocket cost.	Implied cost or notional cost.
7. Profit calculation: Accounting profit and economic profit is calculated.	Only economic profit is calculated.
8. Expenditure incurred: There is expenditure incurred.	There is no expenditure incurred.
9. Examples: Salaries and wages, rent paid, purchase of Raw Materials, etc.	Salary to proprietor, interest on owned capital, etc.
10. Occurrence: Actual and real in nature.	Notional in nature.

- **Fixed costs:** Fixed costs are those costs that do not change in the short run period of time. Fixed costs remain the same regardless of the amount of production and sale of commodities. These costs are incurred by the company irrespective of its production, i.e. even at zero production, the firm incurs fixed cost. A fixed cost can be defined as follows:
  "A fixed cost is the cost that remains the same and fixed irrespective of the production of goods."

Uses of fixed cost:

1. Useful in evaluating break – even analysis;
2. Helps in pricing strategy;
3. Helps in decision – making;
4. Helps in controlling variable costs;

- **Variable Cost:** A variable cost is that cost which changes in short – run and long – run time period. It always keeps on changing. These costs are incurred during production process and thus are the costs incurred for employing various factors of production. A fixed cost becomes a variable cost in the long – run. A variable cost is defined as follows:-

  "A variable cost is the expenditure incurred on the production of goods and therefore is ever changing."

Uses of variable cost:

1. Helps to set prices for the commodity;
2. Helps to plan profits;
3. Helps in decision making;
4. Helps in cost control;

- **Distinction between fixed cost and variable cost:**

Fixed cost	Variable cost
1. Meaning: Fixed costs are costs that are fixed and have to be incurred irrespective of production of goods.	Variable costs are costs that are not fixed and keep on changing as per the production of goods.
2. Nature: These costs are fixed.	These costs are not fixed.
3. Occurrence: These costs occur even when the there is no production of goods.	These costs occur only when there is production of goods.

4. Changes: Fixed cost only in the long run.	Variable cost changes in short run as well as long run.
5. Other names: Other names for fixed costs are Overhead costs or supplementary costs.	Other names for variable costs are Prime costs.
6. Examples: Depreciation charges, maintenance costs, property taxes, interest, rent, etc.	Electricity charges, raw material purchases, conveyance, salaries and wages, etc.

- **Accounting Costs:** Accounting costs are those costs that a firm actually incurs. These costs are explicit costs. There is an actual expenditure which is kept in records for future reference. An accounting cost is defined as follows:-

  "An accounting cost is the actual expenditure incurred by the producer in the course of business. These expenses also have a written record."

  Uses of accounting cost:

1. It shows the expenditure incurred on production of the commodity which is considered for pricing strategy;
2. It also helps in calculating profits;
3. It helps in decision – making;

- **Economic Costs:** Economic costs are those costs that an entrepreneur incurs while conducting economic activities. For an entrepreneur an economic activity is his business. Therefore, economic costs include all the direct and indirect that the entrepreneur incurs while conducting business. An economic cost is the summation of explicit cost and implicit cost. An economic cost is defined as follows:

"An economic cost is the combination of direct and indirect costs that are incurred by the firm to produce commodities."

Uses of economic cost:

1. It shows the expenditure incurred on production of the commodity which is considered for pricing strategy;
2. It also helps in calculating profits;
3. It helps in decision – making;
4. It helps in decision making
5. It helps to ascertain opportunity costs
6. They directly impact profitability of the firm

Difference between accounting cost and economic cost:

Accounting cost	Economic cost
1. Meaning: An Accounting cost is the actual cost incurred.	An economic cost is the direct and indirect cost.
2. Nature: It is direct or explicit cost.	It is direct as well as indirect cost, i.e. explicit cost and implicit cost.
3. Importance: Useful for financial reporting and tax purposes.	Useful for managerial decision making purposes.
4. Evaluation: Accounting cost = explicit cost	Economic cost = explicit cost + implicit cost
5. Profit evaluation: Accounting cost evaluation helps to find accounting profit. Accounting profit = total revenue - explicit cost	Economic cost evaluation helps to find economic profit. Economic profit = total revenue – total cost

	Where, Total cost = explicit cost + implicit cost
6. Users: Accounting cost is used by an accountant.	Economic cost is used by an economist.