CONCEPTS OF COST

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- **Meaning of Production Cost**

Every firm or producer has to arrange various factors of production for the production .The expenditure incurred by a producer (Explicitly or Implicitly) made for using these factors in the production process is termed as 'Cost of Production'

CONCEPTS OF COST

- **Different Kinds of Cost Concepts.**
- Money Cost and Real Cost.
- Explicit Cost and Implicit Cost.
- Actual Costs and Opportunity Costs.
- Accounting Cost and Economic Cost.
- Marginal and Incremental costs .
- Direct costs and indirect costs .
- Fixed costs and variable costs.
- Shutdown cost and Abandonment Cost

CONCEPTS OF COST

- **Money Cost and Real Cost**
- Cost of Production measured in terms of money is called the “Money Cost”. Money cost is the monetary expenditure made by the producer for hiring various factors of production. According to **J.L. Hanson** “The money cost of producing a certain output of a commodity is the sum of all the payments to the factors of production engaged in the production of the commodity.”

CONCEPTS OF COST

- **Money Cost includes:**
- Expenditure on Raw material ,
- Wages and salaries,
- Expenditure on machinery and equipment and the needed repairs,
- Interest paid on Capital,
- The payment for Materials,Power,Light,Fuel and Transportation.
- The Disbursement of Rents,Trademarks,Advertisement and Insurance and the Taxes.
- Depreciation,
- Management Expenses.

CONCEPTS OF COST

- **Real Cost**: This concept was propounded by Marshall. Efforts and sacrifices made in the production process create real cost. Real costs are also termed as social cost because the society faces a number of difficulties during the production process. When cost is expressed in terms of physical or mental efforts put in by a person in the making of a product, it is called as real cost. It refers to the physical, mental or psychological efforts, the exertions, sacrifices, the pains, the discomforts, displeasures and inconveniences which various members of the society have to undergo to produce a commodity

- According to Marshall, ”The exertion of all the different kinds of labour that are directly or indirectly involved in making it together which the abstinences or rather the waiting required for saving the capital used in making it: all these efforts and sacrifices together will be called the real cost of production of the commodity”.

CONCEPTS OF COST

- **Explicit Costs and Implicit Costs**
- Explicit Cost
- Expenditure incurred by the producer on the purchase of inputs from the market is called **Explicit Cost .**For Example**:** payments made by an entrepreneur to the factors of production [excluding himself] in the form of rent, wages, interest and profits, utility expenses, and payments for raw materials etc. It can be estimated and calculated exactly and recorded in the books of accounts.

CONCEPTS OF COST

- ## Implicit Cost
- All inputs may not be purchased from the market. A producer may use some self –owned inputs. Example: Instead of hired workers from the market , producer may use his family labour, A producer may use his own land instead of taking it on lease, etc. Estimated expenditure on the use of these self-owned inputs is called **Implicit Cost.** They do not take the form of cash outlays and as such do not appear in the books of accounts.
- ## Items included in Implicit Costs:
- Remuneration of services given by entrepreneur himself
- Interest of the capital supplied by the entrepreneur .
- Rent of Land or premises belonging to the entrepreneur himself and used in his production.
- Normal Profit (The minimum return which the entrepreneur must receive to continue the production process),compensation needed for his management and organizational activity.
- In Economics, Total Cost is estimated considering both its elements-Explicit Cost and Implicit Cost.

Total Cost=Explicit Cost+Implicit Cost.

CONCEPTS OF COST

- **Actual costs and Opportunity Costs**
- Actual costs are also called as outlay costs, absolute costs and acquisition costs. They are those costs that involve financial expenditures at some time and hence are recorded in the books of accounts. They are the actual expenses incurred for producing or acquiring a commodity or service by a firm. For example, wages paid to workers, expenses on raw materials, power, fuel and other types of inputs. They can be exactly calculated and accounted without any difficulty.

- Opportunity Cost: This is the cost of the resources foregone, in order to get or obtain another. The opportunity cost of anything is the next best alternative that could be produced instead by the same factors or by the equivalent group of factors ,costing the same amount of money. Hence, The opportunity cost of a factor refers to its value available in its next best alternative use. For example, Suppose a person quits his job of Rs. 8,00000 per year and opens his own small business . Although , the accounting cost to his from his own business is zero , the opportunity cost is Rs. 8,00000 per year.

CONCEPTS OF COST

- **Accounting Cost and Economic Cost**
- **Accounting Cost:** When an entrepreneur undertakes an act of production he has to pay prices for the factors which he employs for production. He thus pays wages to workers employed, prices for the raw materials, fuel and power used , rent for building he hires, and interest on the money borrowed for doing business. All these are included in his cost of production and are termed as accounting cost. Thus accounting cost constitute those cost only which involve cash payments by the entrepreneur of the firm.
- **Economic Cost:** Economic Costs take into account not only these accounting cost but in addition ,they also take into account the amount of money the entrepreneur could have earned if he had invested his money and sold his own services and other factors in the next best alternative use.
- Accounting Costs are also called explicit costs whereas the costs of factors owned by the entrepreneur himself and employed in his own business are called implicit costs. Thus Economic Cost include both accounting cost and implicit cost.

CONCEPTS OF COST

- **Marginal and Incremental costs**
- Marginal cost implies additional cost incurred to produce an additional unit of output. It has nothing to do with fixed cost and is always associated with variable cost.
- Incremental cost on the other hand refers to the costs involved in the production of a batch or group of output. They are the added costs due to a change in the level or nature of business activity. For example, cost involved in the setting up of a new sales depot in another city or cost involved in the production of another 100 extra units.

CONCEPTS OF COST

- **Direct costs and indirect costs**
- Direct costs are those costs which can be specifically attributed to a particular product, a department, or a process of production. For example, expenses on raw materials, fuel, wages to workers, salary to a manager etc are direct costs. On the other hand, indirect costs are those costs, which are not traceable to any one unit of operation. They cannot be attributed to a product, a department or a process. For example, expenses incurred on electricity bill, water bill, telephone bill, administrative expenses etc.

CONCEPTS OF COST

- **Fixed costs and variable costs.**
- Fixed costs are those costs which do not vary with either expansion or contraction in output. They remain constant irrespective of the level of output. They are positive even if there is no production. They are also called as supplementary or over head costs. On the other hand, variable costs are those costs which directly and proportionately increase or decrease with the level of output produced. When output is zero ,these costs are also zero. They are also called as prime costs or direct costs.

CONCEPTS OF COST

- **Shutdown cost and Abandonment Cost**
- Shutdown costs are required to be incurred when the production operations are suspended and which could be saved if the production operations continue. For example, if the production is suspended , the machinery and equipment will have to be protected by putting up sheds, using tarpaulin, plastic sheets etc. Such costs are called Shutdown costs.
- When any plant is to be permanently closed down , some costs are to be incurred for disposing of the fixed assets. These costs are called Abandonment Costs.