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• Unit II :- Theory of Cost •

* Cost Concept :-

- Economic cost = Accounting cost + Implicit cost
- Economic Profit = Sale - Accounting Cost

1) Accounting Cost / Explicit cost :-

- Recorded in books of accounts (in P&L A/c)
- Used for Production Purpose
- Cost is incurred
- eg. - Payment of wages, salary, rent, raw materia
- Accounting Profit = Sale - Accounting Cost
- Other Resources

2) Implicit Cost :-

- Not Recorded in Book of accounts
- eg. - If capital invested by owner to his firm
  - Salary of owner
- Given by owner to firm / incurred by owner
- Owner's Resources
  - eg. interest on Capital.

3) Economic Cost :-

- Economic cost = Implicit Cost + Explicit Cost
- Useful for businessmen while taking decision
- Important because an entrepreneure must cove his economic cost if he wants to earn normal Profi ~~Profit~~. • An entrepreneure is said to be earning positiv economic profits only when his revenues are greater than economic cost

4) Outlay Cost :-

- Out of Pocket cost
- Recorded in the Books of accounts.
- Actual expenditures incurred.
  - rent, salaries, material.
- It is concerned with the next best alternative opportunity which was forgone in order to Pursue a certain action.
- Involves a financial expenditure at some ~~tim~~ point of time.
- It is the cost of missed opportunity & invo a comparison between the policy that was choose and the policy that was rejected.

5) Opportunity Cost :-

- Value of sacrifice of next best alternative
- Not recorded in Books of accounts.
- Used for decision making by manager.
- Implicit cost is small part of opportunity cost.
- In long term cost calculation also opportunity cos is a useful Concept.
  - e.g. While calculating cost of higher education. It is not the tuition fee & cost of Books alone that are relevant.

- Example :-

CA

- Job — 10 Lac
- Practice — 5 Lac

O.C. of Job → 5 lac of Practice

O.C. of Practice → 10 lac of Job

Business

- A — ~~Profit = ₹ 8 Loc~~
- B — ₹ 10 lo

Capital = ₹ 10 lac

Bank loan = ₹ 40 Loc

₹ 50 Loc

6) Direct Cost / Traceable Cost :-

- Direct relationship with Production.
- eg. Trading A/c → Direct cost.

7) Indirect Cost :-

- The cost which are not easily and definately Identifi
  e.g. 1] P&L A/c → Indirect cost
  2] Cost of electricity, water, supply cost.
- It does not affect directly on production.

8) Incremental Cost :-

- It refers to additional cost incurred by the firm. as a result of change in decision of the firm.
- eg. change in production process, raw materials.
- eg. 1] To become (fee)

CA	CS
₹ 40,000	₹ 30,000

→ Here ₹ 10,000 is incremental cost.

2] Business

A | B

	A	B
Factory	10 lac	8 Lac
	4 lac	5 lac
	14 lac	13 lac

∴ Incremental cost is 1 lac

9] Historical Cost :-
• The Cost incurred in past and used in decisions.
• eg. 1] 10^{th} Std fees ₹ 10,000 and now doing CA foundation ₹ 30,000.
- The 10^{th} fee is not used/ Undertaken into consideration for doing CA.

10> Sunk Cost :-
• Refer to those costs which are already incurred and and for all cannot be recovered.
• eg. advertisement, R and D, specialised equipments
• Sunk cost at as an important barriers to entry of firms into business.

11> Private Cost :-
• Incurred and provided for by firms and are eithe explicit or implicit.

12> Social Cost :-
• The total cost borne by society on account of a business activity and includes private cost & extern cost.
• It includes cost of resources for which the firm not required to pay price such as atmosphere, rivers, roadways, etc.

Q. ABC Ltd, · Raw material Purchased = 10,00,000
· Wages paid = 500,000
· Prevailing rate of int. = 10% ↔ · Owners capital = 10,00,000
· Prevelling rent = 6,00,000 ↔ · Owners factory = 60,00,000
· Sales = 25,00,000

→ $E.C = A.C + I.C$

$= \begin{pmatrix} 10\ \text{lac} \\ +\ 5\ \text{lac} \end{pmatrix} + \begin{pmatrix} 1\ \text{lac} \\ +\ 6\ \text{lac} \end{pmatrix}$

$= 15\ \text{lac} + 7\ \text{lac}$

$EC = 22\ \text{lac}$

Accounting Profit $= 25\ \text{lac} - 15\ \text{lac}$

$= 10\ \text{lac}$

$E_p = 25\ \text{lac} - 7\ \text{lac}$

$= 18\ \text{lac}$.

IMP Points

- If there is accounting loss, there must be econo[mic] loss.
- If there is economic loss, there may be Accounting loss/profit.
- If both are in profit; Accounting Profit > Economic Profit.
- If both are in loss, Economic loss > Accounting los[s]

- Economic Profit → Supernormal Profit / abnormal Profi
- Economic Profit → Accounting Profit
- Accounting loss → Economic loss
- Accounting profit → Economic profit / loss
- Economic loss → Accounting loss / Profit

* Cost function :-

Cost of output = f (Cost of input given)

Runs

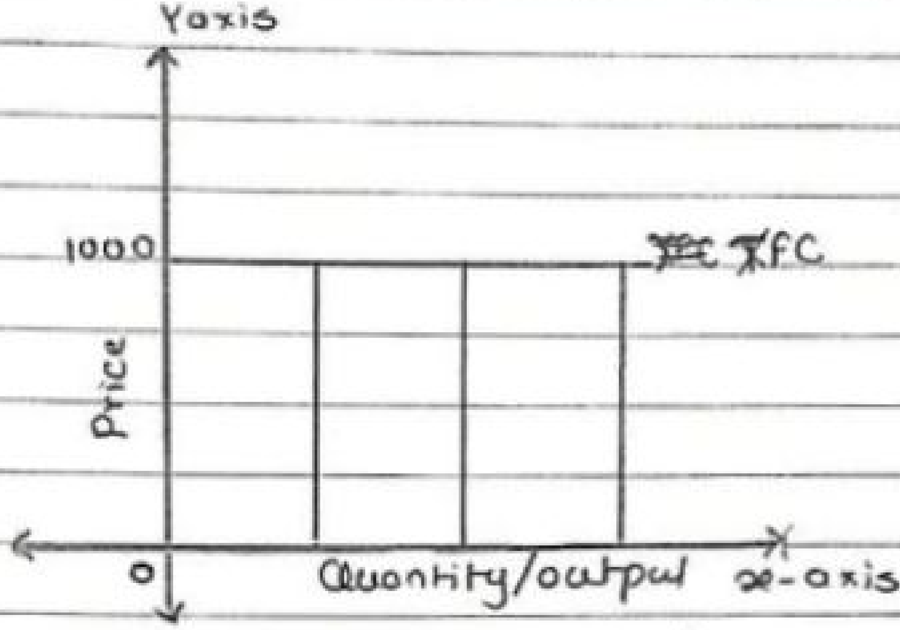
Short Run	long Run
↓	↓
1 cost - fixed Other - variable cost	All cost are variables
↓	↓
Low of variable Proportion	low of returns to scale

* Costs :-

i) Total fixed Cost (TFC) :

- If A started a tution class and takes a hall o rent, so if he teaches 1 student then rent will be 1000 and if he teaches 50 students then rent will be 1000.

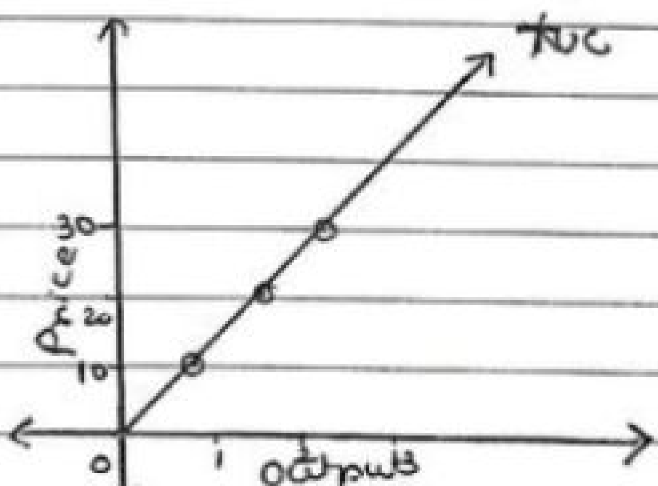
- unit / Qt	₹FC
0	1000
1	1000
2	1000
3	1000



- If output change, cost remains constant.
- It is not dependent on production. It depends up time and capacity.
- Fixed cost can not be avoided.

2) Total Variable Cost (TVC):
- If Output changes, V. Cost changes
- It is dependent on production.
- Direct relationship between VC & Quantity Output.

Units / Output	₹VC
0	0
1	10
2	20
3	30

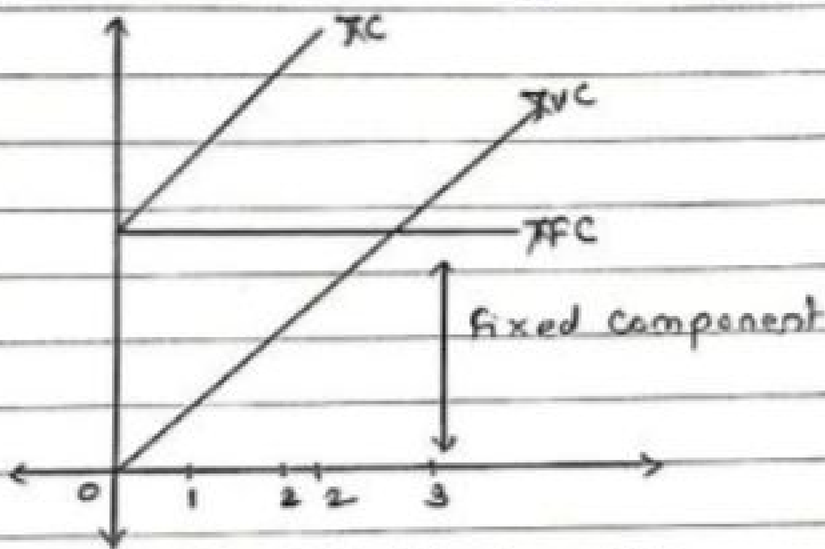


3) Total Cost (TC):

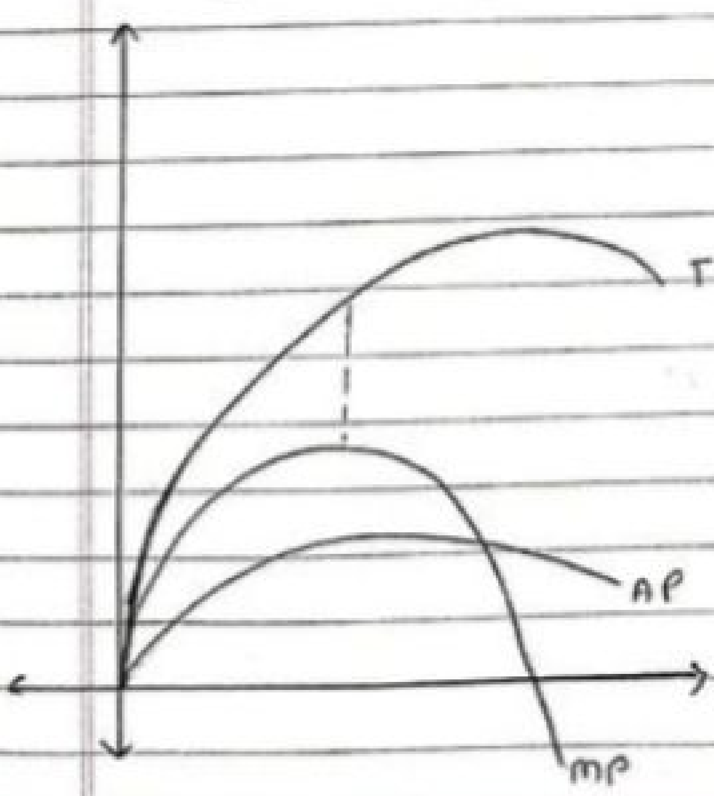
- TC = TFC + TVC
- Also known as semi-variable Cost.

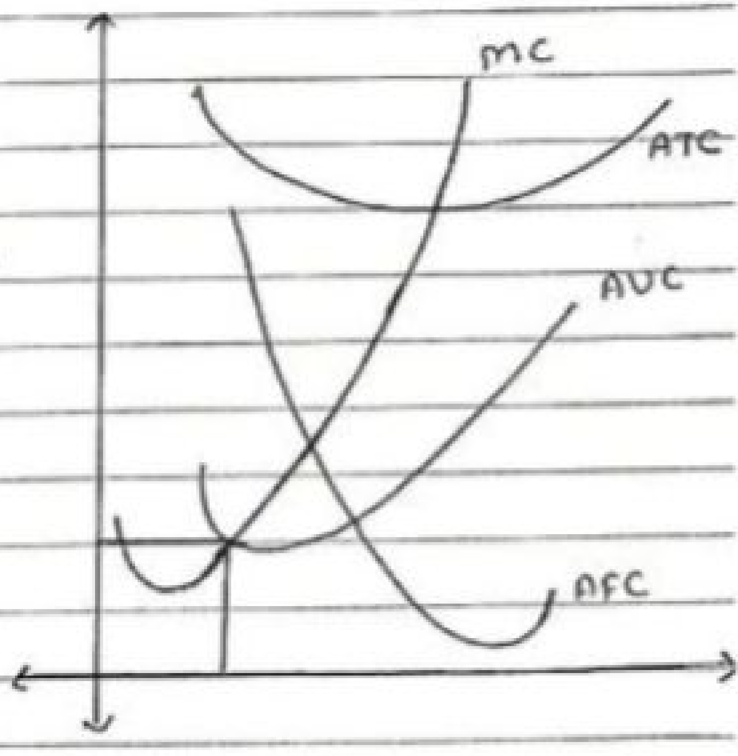
- Units/Output

Units/Output	FC		VC	TC
0	1000	+	0	1000
1	1000	+	10	1010
2	1000	+	20	1020
3	1000	+	30	1030



- eg. Electricity Bill, telephone Bill.





- $AFC = \frac{TFC}{Q}$, $AVC = \frac{TVC}{Q}$
- $MC = \frac{\Delta TC}{\Delta Q}$, $ATC = \frac{TC}{Q}$
- $TC = TFC + TVC$
- $ATC = AFC + AVC$

- When $AVC \downarrow \longrightarrow MC < AVC$

  AVC (Min $\rightarrow MC = AVC$

  $AVC \uparrow \longrightarrow MC > AVC$
- Inverse Relationship betn TFC & AFC
- Direct Relationship betn output & AFC.