

## **MBA- I semester, paper- Managerial Economics, MB 102, TOPIC- Cost Concept.**

### **Cost Concepts**

Costs play a very important role in managerial decisions involving a selection between alternative courses of action. It helps in specifying various alternatives in terms of their quantitative values. The kind of cost to be used in a particular situation depends upon the business decisions to be made. Costs enter into almost every business decision and it is important to use the right analysis of cost. Hence, it is important to understand what these various concepts of costs are, how these can be defined and operationalised. This requires the understanding of the two things, namely, (i) that cost estimates produced by conventional financial accounting are not appropriate for all managerial uses, and (ii) that different business problems call for different kinds of costs.

### **Future and Past Costs**

Futurity is an important aspect of all business decisions. Future costs are the estimates of time adjusted past or present costs and are reasonably expected to be incurred in some future period or periods. Their actual incurrence is a forecast and their management is an estimate. Past costs are actual costs incurred in the past and they are always contained in the income statements. Their measurement is essentially a record keeping activity.

### **Incremental and Sunk Costs**

Incremental costs are defined as the change in overall costs that result from particular decisions being made. Incremental costs may include both fixed and variable costs. In the short period, incremental cost will consist of variable cost — costs of additional labour, additional raw materials, power, fuel, etc. — which is the result of a new decision being taken by the firm. Since these costs can be avoided by not bringing about any change in the activity, incremental costs are also called avoidable costs or escapable costs. They are also called differential costs.

Sunk cost is one which is not affected or altered by a change in the level or nature of business activity. It will remain the same whatever the level of activity.

Example: The most important example of sunk cost is the amortisation of past expenses, e.g., depreciation

## **Out-of-Pocket and Book Costs**

Out-of-pocket costs are those that involve immediate payments to outsiders as opposed to book costs that do not require current cash expenditure.

Example: Wages and salaries paid to the employees are out-of-pocket costs while salary of the owner manager.

If not paid, it is a book cost. The interest cost of owner's own fund and depreciation cost are other examples of book costs. Book costs can be converted into out-of-pocket costs by selling assets and leasing them back from the buyer.