MBA- I semester, paper- Managerial Economics, MB 102, TOPIC- ACCOUNTING COSTS AND ECONOMIC COSTS

ACCOUNTING COSTS AND ECONOMIC COSTS

Accounting cost, like accounting profit, follows the basic principles of accounting In simpler terms, accounting cost is the overall cost of anything your business has paid for.

These costs include the following:

- Rent
- Utility expenses
- Food and entertainment expenses
- Travel expenses, including transportation and hotels
- Payroll expenses, including salaries and taxes.
- Supplies
- Insurance
- Any other expenses incurred during the normal course of business

Economic cost is calculated by taking your accounting cost, which has already been calculated, and also subtracting any implicit costs.

Implicit costs are calculated by analyzing your current resources and estimating the cost of those resources, as well as their impact to your business, should you decide to utilize them in a different way.

For a long time, there has been a considerable disagreement among economists and accountants on how costs should be treated. The reason for the difference of opinion is that the two groups want to use the cost data for dissimilar purposes.

Accountants always have been concerned with firms' financial statements. Accountants tend to take a retrospective look at firms finances because they keep trace of assets and liabilities and evaluate past performance. The accounting costs are useful for managing taxation needs as well as to calculate profit or loss of the firm. On the other hand, economists take forward-looking view of the firm. They are concerned with what cost is expected to be in the future and how the firm might be able to rearrange its resources to lower its costs and improve its profitability. They must therefore be concerned with opportunity cost. Since the only cost that matters for business decisions are the future costs, it is the economic costs that are used for decision-making.

Accountants and economists both include explicit costs in their calculations. For accountants, explicit costs are important because they involve direct payments made by a firm. These explicit costs are also important for economists as well because the cost of wages and materials represent money that could be useful elsewhere. We have already seen, while discussing actual costs and opportunity costs, how economic cost can differ from accounting cost.

In that example we have seen how a person who owns business chooses not to consider his/her own salary. Although, no monitory transaction has occurred (and thus would not appear as an accounting cost), the business nonetheless incurs an opportunity cost because the owner could have earned a competitive salary by working elsewhere.

Accountants and economists use the term 'profits' differently. Accounting profits are the firm's total revenue less its explicit costs. But economists define profits differently. Economic profits are total revenue less all costs (explicit and implicit costs). The economist takes into account the implicit costs (including a normal profit) in addition to explicit costs in order to retain resources in a given line of production. Therefore, when an economist says that a firm is just covering its costs, it is meant that all explicit and implicit costs are being met, and that, the entrepreneur is receiving a return just large enough to retain his/ her talents in the present line of production. If a firm's total receipts exceed all its economic costs, the residual accruing to the entrepreneur is called an economic profit, or pure profit.

Example of Economic Profit and Accounting Profit Mr. Raj is a small storeowner. He has invested Rs. 2 lakhs as equity in the store and inventory. His annual turnover is Rs. 8 lakhs, from which he must deduct the cost of goods sold, salaries of hired staff, and depreciation of equipment and building to arrive at annual profit of the store. He asked help of a friend who is an accountant by profession to prepare annual income statement. The accountant reported the profit to be Rs. 1.5 lakhs. Mr. Raj could not believe this and asked the help of another friend who is an economist by profession. The economist told him that the actual profit was only Rs. 75,000 and not Rs. 1.5 lakhs. The economist found that the accountant had underestimated the costs by not including the implicit costs of time spent as Manager by Mr. Raj in the business and interest on owner's equity. The two income statements are shown below:

Income statement prepared by accountant			Income statement prepared by economist		
	Rs	Rs		Rs	RS
Sales		800000	Sales		800000
Explicit costs					
Cost of goods sold	6,00,000		Explicit costs Cost	6,00,000	
Salaries	40,000		Cost of goods sold	40,000	
Depreciation	10,000	650000	Depreciation	10000	650000
			Implicit costs		
			Salary to owner Manager	50,000	
			Interest on owners' equity	25,000	75,000
ACCOUNTING PROFIT		150000	ECONOMIC PROFIT		75,000