# COSTS

# WHAT ARE  COSTS?

All payments or expenses made by a firm in the production of a good or service are called the cost of production. These costs can be classified in different ways.

# FIXED AND VARIABLE COSTS

**Fixed costs** are expenses that do not change in proportion to the activity of a business, *within the relevant period or scale of production*. For example, a retailer must pay rent and utility bills irrespective of sales.

Variable costs by contrast change in relation to the activity of a business such as sales or production volume. In the example of the retailer, variable costs may primarily be composed of inventory (goods purchased for sale), and the *cost of goods* is therefore almost entirely variable.

# MARGINAL AND OPERATING COSTS

**Marginal cost** is the change in total cost that arises when the quantity produced changes by one unit. In general terms, marginal cost at each level of production includes any additional costs required to produce the next unit. So, the marginal costs involved in making one more wooden table are the additional materials and labour cost incurred

An operating cost is an expense associated with day-to-day business activities and may be variable or fixed. An example of an operating cost is a company's inventory.

# SUNK COSTS

A sunk cost is a cost that an entity has incurred, and which it can no longer recover by any means.Sunk costs should not be considered when making the decision to continue investing in an ongoing project, since you cannot recover the cost. However, many managers continue investing in projects because of the sheer size of the amounts already invested in the past. They do not want to "lose the investment" by curtailing a project that is proving to not be profitable, so they continue pouring more cash into it. Rationally, they should consider earlier investments to be sunk costs, and therefore exclude them from consideration when deciding whether to continue with further investments.

*Training. A company spends $20,000 to train its sales staff in the use of new tablet computers, which they will use to take customer orders. The computers prove to be unreliable, and the sales manager wants to discontinue their use. The training is a sunk cost, and so should not be considered in any decision regarding the computers.*

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