Direct costing and generally accepted accounting principles--toward full recognition

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DIRECT COSTING AND GENERALLY ACCEPTED ACCOUNTING
PRINCIPLES—TOWARD FULL RECOGNITION

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CHAPTER I
INTRODUCTION

Cost accounting is that branch of accounting that deals with the classification, recording, allocating, summarizing and reporting of current and prospective costs. Included in the field of cost accounting are design and operation of cost systems and procedures; methods to be used in assigning costs and evaluating method for finished products.

Direct costing, a fairly recent concept in cost accounting, is a method whereby only the marginal or variable costs are assigned to the product. Since this method can produce results materially different from conventional methods, it would not be generally accepted for audit reports. Likewise, these same differences make direct costing inappropriate for general purpose statements.

Purpose of the study.—Although there has been no codified group of accounting principles written, there is that body of recognized methods and procedures that is known as "generally accepted accounting principles." Reports and statements prepared by accountants are governed by this body of standards and procedures.

The purpose here is to show that, since accounting is not static, more terms, concepts and procedures come within its boundaries as businesses and industries become more complex.
Direct costing is a procedure that is useful in many ways and as more firms adopt it for internal reports and analysis, it will constantly move toward full acceptability.

**Development and scope of study.**—Generally accepted accounting principles will be defined and discussed in detail. Present meanings of generally accepted accounting principles and historical meanings of generally accepted accounting principles will be explored. The history of generally accepted accounting principles will be traced from its original meaning and usage to its present meaning and usage.

Direct costing will be dealt with from a historical point of view. The origination of the direct costing method, its uses and purposes over the years and the present trends in direct costing will be discussed. Also the direct costing method will be explained in detail.

Numerous articles have been written on "direct costing." Some of these articles deal with direct costing and its management merits. Others discuss its problems and roadblocks in the move toward acceptance. On "generally accepted accounting principles," much more has been written over the years. The discussion here will be limited, however, to the uses and practical advantages of direct costing and the conflict of direct costing and generally accepted accounting principles.

The next portion of this chapter will be devoted to defining terms and phrases used in the study. After which, a
brief history of direct costing will be presented.

Direct costing.—Direct costing as is used in this study is a method of assigning costs to a product. Since there are other cost accounting terms that are similar but are quite different in meaning, confusion could possibly arise as to the meaning of the terms.

Direct costing is not the same as direct costs. In fact, the term direct costs as generally used in cost accounting refers to the costs chargeable directly to a product or operation with which they are readily and definitely identifiable. Mostly this would include the principal materials and direct labor used in manufacturing a product or in some other operation.

Direct costing is defined as follows:

Direct costing is a system of cost accumulation and income calculation in which fixed production costs are charged to income currently and only variable production costs appear in inventories. In Great Britain it is called "marginal costing." The system is used chiefly because it is considered more helpful as a management tool than the conventional method. It provided an income statement in which the variable costs of goods sold are deducted from sales to obtain a margin over variable costs. From this the fixed costs incurred or recognized during the period are deducted to obtain a net operating income. The method is based on the contribution theory. From this viewpoint each dollar of sales consists of two things: (1) the out of pocket cost of producing this unit of product as distinguished from the costs associated with the plant facilities as a whole, i.e., its variable cost, and (2) the remainder of the sales dollar. The remainder is then considered a contribution to cover the fixed costs and perhaps produce a profit.1

From the above definition, it can be seen why the terms "variable costing" and "marginal costing" are also sometimes used instead of direct costing. While the term direct costing has been accepted as the official designation, some authorities feel that the term "variable costing" would be more descriptive and lead to less confusion. However, the term "direct costing" will be the term generally used in this study.

**Generally accepted accounting principles.**—Generally accepted accounting principles are defined as follows:

Generally accepted accounting principles consist of a body of conventional and recognized methods of handling accounting data and preparing financial statements. Specific examples of these principles include such firmly established concepts as (a) the determination of net income by deduction of all costs expiring during a period, and (b) the use of cost as a basis of accounting for assets. The doctrine of full disclosure in financial statements has already been discussed; it might be regarded as another fundamental principle of accounting.\(^1\)

**Variable costs.**—Variable costs (or expense) are defined as follows:

An operating expense, or operating expenses as a class, that varies directly sometimes proportionately with sale or production volume, facility, utilization, or other measurement of activity; example: materials consumed, direct labor, power, factory supplies, depreciation (on a production basis), . . .\(^2\)

Variable costing is the process of segregating the variable


and fixed components of manufacturing overhead costs in the accounting records and in the product cost records. Direct labor and direct materials are handled under variable costing exactly as they are under absorption costing. Only manufacturing overhead is processed differently.

**Fixed costs.**—Fixed costs are those that tend to remain relatively constant in total even though there are changes in the volume of business activity. As the units produced change, the per unit cost varies. Fixed costs (or expense) are defined as follows:

An operating expense, or operating expense as a class, that does not vary with business volume. Examples: interest on bonds; rent; property tax; depreciation (sometimes in part). A cost designated as fixed is often a function of capacity, and thus, although fixed with respect to volume, varies with the size of the plant. Or, one department of a plant may bear a monthly service charge originating in another department; to the former, the charge is looked upon as a fixed cost beyond its immediate control; to the latter, the charge may in a large measure derive from variable costs over which it has primary control. Fixed costs are not fixed in the sense that they do not fluctuate or vary; they vary, but from cases independent of volume. Although usually defined with respect to volume, the term may also be applied when some other factor is the independent variable and cost the dependent variable.¹

**Absorption costing.**—Absorption costing as used in this study means a cost system in which no distinction is made between variable or fixed costs. That is, in the accounts, the costs are classified as either direct or indirect. Hence, if information is desired about the relationship between cost,

volume and profit, supplementary statistical analysis are required.

Absorption costing is also referred to as total or full costing. Generally this is to contrast absorption costing with the earlier defined direct costing which excludes from product cost the fixed portion of manufacturing overhead. Other terms which are used synonymously are conventional cost accounting and historical cost accounting.

**Direct costs.**--The term direct costs as used here is a classification of absorption costing. Generally, a direct cost is any cost that is specifically traceable to a particular costing unit. That is to say, traceable without serious argument as to the validity of the identification. Some examples of direct costs used in the manufacturing of desks would be the direct labor, lumber, nails, and hardware.

**Indirect costs.**--The term indirect costs is also used in connection with absorption costing. An indirect cost is any cost that cannot be identified with a particular costing unit without resorting to some arbitrary rule or procedure. As to indirect materials, those that are used in the manufacturing operation but do not become a part of the article manufactured. For instance, abrasives, polishing oils, and waste rags are indirect materials. Likewise, indirect labor is that portion of factory labor cost which it is not possible or practical to identify with specific jobs or, in some cases, with specific departments.
CHAPTER II

WHAT IS MEANT BY GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Over the years the development of accounting principles and practice has been closely related to the economic development of the country. In the early stage of the accounting profession the objective was to prove the financial data of an enterprise in the form of an income statement and a balance sheet. These statements were used by owners and creditors to evaluate the results of operation and financial position. During this period usually the manager of the business was the owner and if substantial amounts were owed to bankers or creditors, such persons would participate in management decisions.

With gradual increases in the size and complexity of businesses, the management became more and more a separate group from the outsiders. These outsiders included creditors, stockholders, government, labor unions and the general public. With these developments and gradual increases in complexity came the awareness of the need for a framework of concepts and generally accepted accounting principles.

If one could imagine having each accountant in the country decide how his statement would be arranged, what would be used and what would control the classification in these statements, the results would most definitely be chaotic. A creditor,
stockholder or potential investor could not understand or consider reliable any statement prepared by an accountant unless fully explained. Not only would this have an adverse effect upon our present economic system but also it would practically eliminate the accounting profession. Therefore, it was necessary to provide a body or generally accepted accounting principles.

How the phrase generally accepted was adopted.—Accounting often is called the language of business since it is a primary tool in the control of operations and in reporting accomplishments of commercial entities. A full understanding of the derivation and meanings of accounting terms is therefore our purpose here.

Accountants are generally agreed that accounting principles cannot be derived from or proven by the laws of nature. They are rather in the category of conventions or rules developed by man from experience to fulfill the essential and useful needs and purpose in establishing reliable financial and operating information control for business entities.

Principles are derived from experience in observing the conduct of business and accepted principles are derived from long usage and experimental process.

The term "generally accepted accounting principles" came into general use in the reports of certified public accountants as a result of the correspondence between an Institute committee and the New York Stock Exchange. It was proposed that listed corporations be asked to adhere to certain broad
principles of accounting which had fairly general acceptance, and that within the limits of such broad principles they be permitted to select detailed methods of accounting deemed by them to be best adapted to their business, but that they be required to disclose their accounting methods and to undertake not to make material changes in these methods without due notice to interested persons. It was thought that this would promote consistency, and would tend to bring about the elimination of less desirable practices by exposing them, although it was recognized that improvement would be gradual. Independent auditors were to be required to express an opinion as to whether the financial statements conformed with the methods purported to be followed, and whether those methods were in accordance with good standards, that is with "accepted accounting principles." It was later that the word "generally" was added.

The above proposal by the American Institute and the New York Stock Exchange was not put into effect in the specific form in which it was made. Much of the reasoning behind it, however, has come to be accepted as a basis for current practice, and the expression "generally accepted accounting principles" has come to be almost universally used by independent auditors in reporting on their examinations or financial statements.

The New York Stock Exchange has had considerable influence over the years in improving financial reporting of business
corporations. This influence is exercised through the standards of information set forth in listing requirements which the companies agree to maintain in subsequent reports to the Exchange and to stockholders. The prestige of the practices of listed companies has in turn served as an example in raising the reporting practices of all companies whose securities are held by the public. The stock exchanges also maintain continuous surveillance over the interim and annual reports of listed companies to detect misleading statements, material omission and violations of listing agreements.

Considerable work between the Institute Committee and a Committee of the Controllers Institute of America, predecessor to the Financial Executives Institute, resulted in the words "principles" and "practices" being used interchangeably. In this same correspondence, it was made clear that an opinion in the accountant's report that statements present fairly and in accordance with accepted accounting principles will not be understood as implying that all of the clients of a given firm observe similar or equally conservative practices. This was true in the case of companies engaged in the same industry, or in the case of companies in different industries.

In 1938, the American Institute formed a committee on accounting procedure and established a research department to undertake studies of accounting questions. It inaugurated a series of accounting research bulletins, fifty-one of which were issued during the next twenty-two years. These relate
to particular issues or problems of practicing accountants, and do not present a comprehensive outline of accounting principles.

The committee itself announced at the beginning of the above undertaking that its plans would be:

to consider specific topics, first of all in relation to the existing state of practice, and to recommend, wherever possible, one or more alternative procedures as being definitely superior in its opinion to other procedures which have received a certain measure of recognition and, at the same time, to express itself adversely in regard to procedures which should in its opinion be regarded as unacceptable.¹

The committee also pointed out that, in dealing with each case, especially where there were alternative methods which appeared to possess substantial merits, it would take into account the conflict which created the situation, and thus gradually prepare the way for a further narrowing of choices.

In the early years of correspondence, and formation of accounting terms and concepts, words like "principles" and "practice" were used and therefore constitute somewhat of a background for our present terms. As is true in other areas of accounting, the American Institute has played an important part in the development of generally accepted accounting principles.

The report developed out of the correspondence between the American Institute of accountants (now the American Institute of Certified Public Accountants) and the New York

Stock Exchange was most definitely a step forward in reports prepared by members of the profession. During the period 1934 through 1939, this report was used somewhat as an authority for reports written by accountants. The McKesson and Robbins case prompted the appointment of a committee on auditing procedure in 1939. The report of the committee entitled "Extensions of Auditing Procedure" was approved at the 1939 annual meeting of the American Institute of Certified Public Accountants. The committee recommended that the short form be revised and also proposed that the wording in the opinion paragraph be changed with regard to accounting principles. The revised wording was "in conformity with generally accepted accounting principles." This was the first use of the word "generally" in this connection; as in the past, correspondence and reports had only used the phrase "accepted accounting principles."

**Generally accepted accounting principles over the years.**

During the period beginning in 1936 and ending in 1959, contributions to an articulated body of accounting principles came from two main sources. The first of these sources was the American Accounting Association. Beginning in 1936, the Association, through the efforts of its executive committee published a statement of principles underlying the preparation and presentation of financial statements. The second of these sources was the American Institute of Certified Public Accountants. The Institute organized a committee on accounting
procedure (now the Accounting Principles Board) in 1938. On what is sometimes called a practical approach, the committee responded to practical problems of accountants on a case-by-case basis. In other words, the committee considered specific topics as the need arose and, if possible, recommended one or more alternative treatments as superior to the other recognized procedures.

The American Accounting Association set out to improve accounting and reporting practices by strengthening the overall framework which supported accounting practice. Through its executive committee, a research program was initiated as an attempt to formulate and obtain general acceptance for a group of interrelated, consistent, and comprehensive principles of accounting. These principles were to serve as guidelines against which procedures might be judged. The Association was hopeful that the principles that were in conflict with existing practice would serve to point out the need for such principles and because of this, start a movement toward a solution. The Association was aware of practices that were in conflict with each other as well as those that were in conflict with its proposals. In an effort to improve on this, the Association felt that a published group of principles might be adopted as fundamental to sound accounting and to continuously rework, revise and improve them. These principles were published in tentative form in order to invite criticism and comments in the hope that wide discussion would lead to substantial improvements. Although the basic approach and objective were never
changed, it was revised in 1941 and in 1948. In addition, there have been eight supplementary statements released which amplified the coverage and elaborated on the principles enunciated in the original statement. In fact, there are indications that the statement might not be final at the data of this study.

The Committee on Accounting Procedure published serially numbered pamphlets dealing with numerous problems in the accounting profession. The information in these pamphlets as a general rule was in agreement with the statement by the American Accounting Association. The most important of these early publications was bulletin 43. It was published during 1935 by the Committee on Accounting Procedure, and published in the form of a pamphlet entitled "Restatement and Revision of Accounting Research Bulletins." The committee was composed of twenty-one leading accountants. They were selected from large, small and medium-sized accounting firms and a few universities, representing all sections of the country. The Committee on Accounting Procedure is a highly recognized authoritative body. Generally its pronouncements are considered by business executives and those in public accounting practice to be the most authoritative guides to accounting principles available. In many areas where wide disagreement had previously existed, as a result of the work of the committee, these differences have been reduced materially or eliminated entirely.

A comprehensive statement of principles has not been
undertaken and issued by the committee on accounting procedures. Before the issuance of a bulletin by the committee, at least two-thirds of its members must vote in favor of it. Before expressing its opinion in the form of a bulletin, it is the committee's policy to expose its views to a wide variety of accounting thought for comments and criticism. Usually, some statement of its tentative views, either in the form of a preliminary draft of a bulletin or an article for *The Journal of Accountancy*, or a memorandum showing the consensus of the committee, is prepared and distributed to a number of cooperating organizations, whose representatives have been most helpful in making constructive criticism of the committee's proposals. Some of these organizations are the state societies of certified public accountants, the Comptrollers Institute of America, the American Accounting Association, the National Association of Cost Accountants, the Securities and Exchange Commission, the New York Stock Exchange, and the Edison Electric Institute. It should be pointed out that since the above publication, the Accounting Principles Board had undertaken to codify the generally accepted accounting principles. Also, it has now been made official that, with respect to any pronouncements by the Board, such constitutes the position of the American Institute of Certified Public Accountants.

What is now meant by generally accepted accounting principles.--In 1963, a very definite step forward was made in the area of generally accepted accounting principles. The Accounting Principles Board approved a research project to
first identify and then codify the accounting principles for business enterprises that have achieved general acceptance. The November, 1963 issue of The Journal of Accountancy published an outline for the inventory of generally accepted accounting principles and practices for business enterprises.

Also, during the summer of 1963, the Accounting Principles Board had suggested to the executive committee of the AICPA certain rule changes which would require members to direct attention, in their opinion on financial statements, to departures from pronouncements formally issued by the Board. Out of this suggestion came the resolution by the Executive Committee that with regards to the expression of opinion on financial statements, that opinions by the Accounting Principles Board be considered the only generally accepted accounting principles in areas where the Board had spoken. The only exception to this would be where such opinion of the Board had been either modified or rescinded by Council.

The above occurrences during the summer of 1963 made the Accounting Principles Board the official authority for the American Institute of Certified Public Accountants in matters coming under the jurisdiction of the Board. It would therefore be required that a member direct attention to any departures from pronouncements by the Board. An opinion that financial statements were "fairly presented" could be made by the member however, only if he approved the alternative accounting principles followed. Also, the possibility remains that he
could be called upon to justify his approval of the alternative accounting principles followed.

As this study is being made, the Accounting Principles Board still strives to codify what we expect one day to be an exhaustive analysis of generally accepted accounting principles. Certainly, with the accounting publications being dominated by articles on this subject, there is general awareness of such a need and also a feeling that such will improve the accountants position in the business world and in society in general.

The above is not an admission of the absence of generally accepted accounting principles. What the committee proposes is evident from the following statement taken from the Board's charter:

The general purpose of the Institute in the field of financial accounting should be to advance the written expression of what constitutes generally accepted accounting principles, for the guidance of its members and of others. This means something more than a survey of existing practice. It means continuing efforts to determine appropriate practice and to narrow the areas of difference and inconsistency in practice.

What is desired and expected out of the present study of the Accounting Principles Board is a compilation of generally accepted accounting principles presented in a manner which is complete and useful to members of the profession.

It is felt that the above study will have some effect on the definition of accounting principles. It is believed, however, that the effect will be slight and the change will
be gradual. The following is a current definition of accounting principles:

The body of doctrine commonly associated with the theory and procedure of accounting, serving as an explanation of current practices and as a guide for the selection of conventions or procedures where alternatives exist. The formation of accounting axioms and the principles deriving from them have arisen from common experiences, historical precedent, statements by individuals and professional bodies, and regulations of governmental agencies. The validity of accounting principles rests on their simplicity, clarity, and generality in mirroring current practices and in furnishing guidance for the moral conduct of practitioners and for the further development of the profession.¹

¹Kohler, op. cit., p. 13.
CHAPTER III

THE ESSENTIALS OF DIRECT COSTING

How direct costing began.--Direct costing began out of a desire on the part of accountants to give management a better report on operations. One of the distinct shortcomings of historical or absorption cost accounting is that the information comes to management after the goods have been produced and often sold. Moreover, even though this information is supplied to management with the unit cost, total cost and units produced, the information was not organized or analyzed in such a way that it could be very useful in the future.

As mentioned earlier, accounting principles, accounting methods and procedures are all man-made. As our economy grows and becomes more complex these principles, methods and procedures are changed, amended and altered in order to better meet the needs of the economy. Direct costing was no exception.

As accountants were striving to meet the demand of our complex economy, there was a trend toward the exclusion of some or all fixed manufacturing expenses from inventory values. Although it met with much opposition, authorities recognized years ago that this approach to analyzing costs had real merits for internal reports, product planning and other management decisions.

As accountants pushed more and more toward bringing the
gap between the complexities of the business world and the results of historical or absorption costing, the tendency toward excluding the fixed manufacturing overhead was increasing. In order to improve upon the usefulness and practicality of reports, it was necessary to differentiate between fixed and variable cost. The fixed costs were costs that were incurred based on long ranged management decisions. The variable costs were those that were dependent upon current management or supervisory decisions. Certainly from a management point of view, this was a step forward.

During the early part of the twentieth century, various articles appeared in publications by the American Institute of Certified Public Accountants, the American Accounting Association and National Association of Accountants. The National Association of Accountants reported in 1953 that a system providing marginal costing was installed in 1908. This study however, at that time, did not use the term direct costing. The earliest published description of such a cost system was discovered in a N. A. A. study which appeared in 1936. This article "Direct Costing," Research Series no. 23, was written by Jonathan N. Harris. This was apparently the first time the term "direct costing" was used.

Direct costing moved slowly during the next ten years. This was due mostly to the position of the American Institute of Certified Public Accountants (then the American Institute of Accountants) and the American Accounting Association.
Recently, however, there has been a renewed interest in direct costing. Articles in the accounting journals and various discussions on this costing method indicate growing acceptability and interest.

How direct costing works.—The direct costing concept considers the cost of products manufactured to be composed of only those costs that vary with production volume. Fixed overhead costs are excluded from product costs and hence are treated as an expense of the period in which they are incurred.

The system is designed to distinguish between those costs that are fixed and hence would be incurred whether the plant operates at full capacity or less than full capacity, and variable costs that vary with increases and decreases in production. The variable costs are composed of direct materials, direct labor and variable factory overhead. From the above statement, it can be seen why direct costing is sometimes referred to as variable costing. Since the variable overhead and the direct labor and direct materials make up the cost of the product, variable costing is more descriptive of the process than direct costing.

On the other hand costs that are fixed are charged off in the period. Some examples of fixed costs are depreciation on factory building, supervisory salaries and factory insurance. Although the above seems clear, it is admitted that what is a fixed cost and what is a variable cost sometimes overlap. Some costs are sometimes semi-fixed. For example, if plant operations are reduced by five per cent (5%) supervisory salaries would
be fixed. That is, they would not change with such small fluctuation in production. However if production is reduced from 100% to 30%, supervisory salaries maybe reduced materially. Under conditions where such changes are made frequently, most costs are variable.

Not only is the classification of fixed and variable costs affected by frequency or degree of change, management decisions and policies also affect the classification. For example, if management contracts with an outsider to perform some service for a monthly or annual fee, such expense becomes a fixed cost. On the other hand if an hourly employee who worked along with the production crew performed this function, this would be a variable cost.

It is important that the distinction between fixed costs and variable costs be clearly defined and such classification be carried out. One reason for such distinction is that the variable costs charged to and are the responsibility of the department that incurs them. Also such a breakdown is helpful in production pricing, production planning and other management functions.

The variable or marginal costs become a part of the inventory and cost of goods sold in direct costing. As a general rule, the direct labor and direct materials of absorptive costing constitute most of this cost. Added to the labor cost will be the variable part of the manufacturing overhead. Hence the final product has included the cost of direct labor, direct
material and the variable portion of manufacturing overhead. As seen above such classification could be materially, affected by changing conditions in the factory or management decisions.

The following is a typical condensed income statement for a firm using direct costing.

TABLE I
DIRECT COST INCOME STATEMENT
YEAR ENDED DECEMBER 31, 1958

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>$32,000</td>
</tr>
<tr>
<td>Less: direct cost of goods sold</td>
<td>$14,000</td>
</tr>
<tr>
<td>Manufacturing margin</td>
<td>$18,000</td>
</tr>
<tr>
<td>Less: direct selling expense</td>
<td>$4,000</td>
</tr>
<tr>
<td>Merchandising margin</td>
<td>$14,000</td>
</tr>
<tr>
<td>Less: Period costs (fixed costs and expense)</td>
<td></td>
</tr>
<tr>
<td>Fixed factory costs</td>
<td>$5,000</td>
</tr>
<tr>
<td>Fixed selling and administrative expense</td>
<td>3,000</td>
</tr>
<tr>
<td>Other administrative expense</td>
<td>1,500</td>
</tr>
<tr>
<td>Other period expense (such as research)</td>
<td>1,000</td>
</tr>
<tr>
<td>Total Period cost</td>
<td>10,500</td>
</tr>
<tr>
<td>Total Period costs</td>
<td>$3,500</td>
</tr>
</tbody>
</table>


Included in the section of the statement labeled period costs would appear all fixed costs. As explained above, all variable costs of production are charged to the product and are deducted through the cost of goods sold. In addition to the variable cost of production, usually the salaries of salesman and travel expenses are increased in efforts to increase sales. Therefore, in the above statement, in addition to the variable costs of
of production, the variable selling expenses are set out separately.

Table I shows how an income statement would look if a firm used direct costing. This condensed income statement did not show the computation of cost of goods sold. In other words, the ending inventory was not shown in the statement. As the ending inventory has an adverse affect on the cost of goods sold, it has a direct affect on profits and assets in the balance sheet. In other words, the fixed costs omitted from the cost of ending inventory have reduced the profits and assets by an equal amount. Such results have been primarily responsible for direct costing being subject to such lively recent accounting controversies.

Direct costing and special situations.—During the first half of this century, technological advances in the economic and business world were great. As industries became more and more mechanized, fixed manufacturing overhead became an even larger element in cost. Meanwhile, there was in process an effort on the part of accountants to cope with this problem of manufacturing overhead and better service the needs of business. The results of their efforts is now known as "direct costing."

The nature of direct costing is in a formal recognition of the ideas underlying flexible budgets, break even analysis, and revenue cost volume relationships. It is the application of these relationships which involves a change in the conventional treatment of fixed manufacturing overhead in relation
to the determination of income. It is here that direct costing has met with more acceptability and usefulness. Such a breakdown in cost is useful to management for such things as cost studies, proposed changes and projections. Example of such uses will be shown later in this chapter.

Opposition to the use of direct costing for financial reporting makes it more imperative that management merits are justified. That is, because of this opposition, direct costing must provide management with more than absorption costing. If this is not true, direct costing will not suffice. The principal advantage in direct costing is that departmental and product statements can be prepared in such a way as to reflect the sales price as a contribution to fixed overhead and profit. Variable profit, or "P/V income" as it is sometimes called rises and falls with sales assuming constant prices and manufacturing methods. It can be determined quickly and directly what effect a change in the selling price will have on profits. Furthermore, such a cost system permits the presentation of profit contribution statements in a simple form without the use of accounting terminology that is likely to be confusing to nonaccounting executives—terms such as "reduction in underabsorbed burden," "inventory valuation adjustments" and so forth.

In addition to showing current operational levels in a simpler form, the same is true for projections. Suppose management wants to know the consequences of a thirty per cent expansion program. The basic problem for the accountant is additional
fixed costs. After this, the information can be shown to management in simple nonaccounting terms. The following is an example:

**TABLE 2**

**PROJECTION OF OPERATIONS**

<table>
<thead>
<tr>
<th></th>
<th>Present Rate</th>
<th>Proposed</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$100,000</td>
<td>$130,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>45,000</td>
<td>58,500</td>
<td>13,500</td>
</tr>
<tr>
<td>Marginal income</td>
<td>55,000</td>
<td>71,500</td>
<td>16,500</td>
</tr>
<tr>
<td>Fixed costs</td>
<td>10,000</td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>$45,000</td>
<td>$51,500</td>
<td>$16,500</td>
</tr>
</tbody>
</table>

The conventional costing method would require that one first obtain the net product margin and then adjust this for the difference in under or over absorption of fixed costs. Absorption or conventional costing works with full costs averages including fixed costs and the determination of increments from such data can be extremely difficult.

As it is implied in the above statement, it is a fact that patterns of cost variability are more readily apparent under direct costing than under absorption costing. Since under absorption costing such cost data can only be gotten through analysis, it would be easier to obtain under direct costing. In direct costing, unlike absorption costing, much of the identification work on cost variability has already been done.
before the analyst gets the data with which he must work. Although there are problems of costs classification in a direct costing system, it does permit the extraction of short run variable costs directly from the accounting records. This is of particular importance where there are several departments to which and from which goods are transferred. Absorption cost methods tend to convert fixed costs of one department into variable costs of a succeeding department or departments. This is because goods are transferred out of one department at total actual or standard cost. The departments that receive their goods consider the total cost transferred in the cost of materials, and therefore, would be treated as a variable cost. As a result of this, it could require quite an analysis to eliminate the pyramiding and separate the costs into their fixed and variable components. In direct costing, fixed costs are separated beforehand and only the variable costs are transferred to the next department.

Direct costing for production planning.—By giving separate treatment to fixed and variable costs, direct costing permits the effects of the two to be observed separately as volume changes. Management personnel in many cases, is not trained in accounting. Although the conventional cost figures and terminology seem confusing to them, the same information from direct costing records can be interpreted easier.

As soon as the fixed and variable costs are segregated,
it becomes obvious that the fixed cost must be covered before a profit is realized. Also if the variable costs are known per dollar or per unit of product, it becomes an easy matter to calculate the profit at any level of production. That is, the breakeven point and profit or loss at any level of production can be determined mathematically by use of the following:

\[
\text{Profit or loss} = I - \left( \frac{FC}{VC} \right)
\]

where:

- \(I\) = income, which is the number of units produced and sold times the selling price per unit.
- \(FC\) = fixed cost.
- \(VC\) = total variable cost, which is the number of units produced and sold times the variable cost per unit.

Assume that for a particular product, the variable costs are $1.00 per unit. Assume also, that 6,000 units are sold for $1.75 each and that the firms fixed costs are $2,500 using the above equation, the profit of $2,000 is determined as follows:

\[
P = I - \left( \frac{FC}{VC} \right)
\]
\[
= (6,000/u \times $1.75) - ($2,500 / 6,000/u \times $1.00)
\]
\[
= $10,500 - ($2,500 / $6,000)
\]
\[
= $2,000
\]

By the use of an equation, the break-even point can be determined by equating the sales income line to the total cost line. Although the break-even point is important and useful to management in decision making, once the equations are established, they can be used for various purposes for planning and budgeting. First one looks at the break-even
equation:

\[
\text{Break-even point} = \frac{FC}{SIU - VCU}
\]

where:

- SIU = sales income per unit.
- VCU = variable cost per unit.
- FC = fixed cost.

Based on the above information the break-even point could be determined by using the equation as follows:

\[
\text{BEP} = \frac{FC}{SIU - VCU}
\]

\[
= \frac{\$2,500}{\$1.75/U - \$0.75/U}
\]

\[
= \frac{\$2,500}{1.00/U}
\]

\[
= 2,500 \text{ units}
\]

In order to find the break-even point in dollars, one simply multiplies the number of units indicated (2,500) times the sales income per unit ($1.75). In the above example, the break-even point in dollars is $4,375.00.

As mentioned earlier, the above equations can be used for several purposes. They include the answers to questions such as the following:

1. What will be the effect in profits if the company raises or lowers prices?
2. What will be the effect on profit of increases or decreases in costs such as taxes, rent and equipment?
3. How much will profits increase with an increase in production and sales?
4. How much increase in volume will be needed to cover the cost of a wage increase?
The following examples will illustrate how the equations work to answer these questions. Assume that the following problems faces the production manager in a shirt factory. The following facts are available:

1. Fixed cost $400 per week
2. Variable costs $2.50 per unit
3. Selling price $5.00 per unit
4. Production level (present) 100 units per week

What is the profit or loss at the present level of production?

At the present level of production, sales income is $500. The fixed costs are $400 and variable costs are $250. Since income equals fixed costs plus variable costs ($PC + $VC), a loss of $150 will be incurred at the present level of production (500 - (400 + 250)). This leads to a related question. How many units must the factory produce a week to break-even?

Since we have separated the fixed costs from the variable costs, it can be seen that the break-even point will be reached when the excess of sales price over variable costs exactly pays the fixed costs. This excess of selling price over variable cost is referred to as unit contribution. Our break-even point can then be determined as follows:

\[
\text{BEP} = \frac{\text{FC}}{\text{UC}}
\]

where:

\[
\text{UC} = \text{unit contribution, the selling price minus variable costs.}
\]

hence:
BEP = \frac{FC}{UC}

= \frac{400}{2.50/0}

= 160 \text{ units}

To check the computation, one computes the net profit as follows:

Sales income (160 X 500) = \$800 less
Fixed costs = \$400
Variable costs (160 X 250) = \frac{400}{400}
No profit or loss -0-

Naturally, it is not the object of a firm to operate at break-even. Suppose the production manager felt that \$150 per week was a reasonable profit. The question would be, what volume of production would be necessary?

From the original equation, profit equals sales income less fixed and variable costs. If Q is used for volume or quantity of production, this can be expressed as follows:

\[ P = (SIU) (Q) - FC plus (VCU) (Q) \]
\[ = Q (SIU - VCU) - F - C \]
\[ P \neq FC = Q (SIU - VCU) \]

Our new equation expresses the idea that net contribution to fixed costs and profit is the margin between sales income per unit and variable cost per unit. In other words, as production increases, the variable cost increases. However, the unit contribution remains to do two things. First, cover the fixed costs and secondly, produce a profit. Knowing what fixed costs are, what variable costs are, and the desired profits, the equation gives us the following quantity to be produced. It is determined as follows:
In checking one finds that 220 units at \$5.00 each will come to \$1,100 per week. A fixed cost of \$400 plus \$550 variable costs (\$2.50 \times 220 \text{ units}) gives us a total cost of \$950. The sales of \$1,100 minus total costs of \$950 equals \$150 profit. It might be that management decides that production should be increased to yield a certain amount of profit per week. However, in increasing capacity, management might find that present equipment is being utilized at near full capacity. Hence, additional equipment is necessary. After working all of this out, the final conclusion is to purchase additional equipment that will increase fixed costs by \$100. The question now becomes, what effect will this new acquisition have on the situation. Since fixed costs have now been increased to \$500, the new break-even point is increased as follows:

\[
\text{BEP} = \frac{\$500}{\$5.00} - 250 = 200 \text{ units}
\]

The above equipment outlay has caused the break-even point to go up 40 units. If the business wants to increase profits from the above mentioned \$150 weekly to \$200 weekly, then the following computation determines the necessary units. The answer is 280 as follows:

\[
\begin{align*}
\$200 &= \$500 \times Q - (\$500 \times 2.50 \times Q) \\
\$700 &= 250 \times Q \\
Q &= 280
\end{align*}
\]

The above is an example of how the equation can be used and manipulated to determine the effects of fixed costs changes.
on the break-even point, and profit. Similarly, the equation can be used to determine the effects of variable costs changes on the break-even point and profits. For example, assume that management had determined that with the above $500 fixed costs, the $2.50 per unit variable cost and the $200 profit, all was satisfactory. Management also knew that the break-even point was 200 units. Assume further that operations were proceeding on that basis until wage increases had pushed variable cost up to $2.75. In order to compensate for this increase, management decides to raise the selling price to $5.20. The question now becomes what effect will this wage increase have on the situation? If the cost of labor had been the only increase, then the break-even point would be more. If on the other hand, sales were increased with costs or expenses remaining the same, the break-even point would have been lowered. As matters now stand, the increase in costs is exactly equal to the increase in the selling price. Hence, the margin or unit contribution is exactly the same and the break-even point remains at 200 units.
CHAPTER IV

THE CONFLICT OF DIRECT COSTING AND
ACCOUNTING PRINCIPLES

At the outset it seems appropriate to give recognition to the work and acceptability given to direct costing by the National Association of Accountants. This is an organization of cost accountants which was organized in 1919 as the National Association of Cost Accountants. Since the primary concern of this organization is cost accounting, naturally much of what is known about it by accountants and nonaccountants would come from this source.

As a result of the organization of the concept and a closer association with cost accounting, the National Association of Accountants in general feels stronger about the usefulness and acceptability of direct costing than does the American Institute of Certified Public Accountants or the American Accounting Association. The latter two accounting organizations were mentioned earlier in the study. Both support the view that direct costing is advantageous to management. However, neither feels that it is acceptable for external reports and financial statements.

The reasons for their positions on this concept seemingly lie in earlier published accounting studies. They are (1) the Restatement and Revisions of Accounting Research Bulletins (a 1953 publication by the American Institute of Certified Public
Accountants, and known as Bulletin 13, and (2) Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements (a publication by the American Accounting Association and was last revised in 1957). In both of the above publications, the position taken was that the cost of a product for the purpose of determining unit cost (and therefore the cost of inventory), and the preparation of statements for external purpose must include the fixed manufacturing overhead. The advocates of direct costing feel that stand-by costs (those costs that would be incurred whether or not goods were produced) should not be assigned to the units produced.

A comparison of direct costing with absorption costing.— Earlier in this study, the benefits or advantages of direct costing were mentioned. At this juncture the concern is with the concurrent problems and acceptability of direct costing. Although a specific identification of the problems will be made later, at present a comparison of direct costing and absorption costing will be made.

Under absorption costing, all of the manufacturing overhead is allocated to and becomes a part of the cost of the product. In contrast to the above approach, direct costing includes in product cost only those variable elements of manufacturing overhead treating fixed costs as a general charge against all operations combined and not against any specific segment of operations. As this concept is reflected in the
financial statements, variable manufacturing overhead costs are included in the cost that pass through the product inventory accounts; all fixed costs are treated as expenses of the period in which the expiration is recognized. These fixed manufacturing overhead expenses (or cost) are thus taken directly to the income statement without passing through product inventory accounts.

The fact that these two concepts lead to two different measures of periodic income is not the most important distinction between direct costing and absorption costing. It is that they provide different measures of the relative profitability of individual products, branches or other divisions of a company's business. As was explained in a report by the National Association of Accountants:

Direct costing has sometimes been described as a plan for eliminating fixed costs from inventories. This description stresses an incidental feature rather than the prime objective of the plan, which is provision of information about cost-volume profit relationships.¹

In implementing the direct costing approach, either the actual portion of variable manufacturing overhead cost can be applied to production as is done in absorption costing or the charge can be made based on a predetermined rate. To illustrate, assume that the burden rate for variable manufacturing overhead is $2.00 per direct labor hour and that a total of 7,000 direct labor hours are recorded, then the entry to record

In contrast, the fixed component of manufacturing overhead is treated as a joint cost of all operations of the period. The fixed cost may be compared with budget allowances or shown on departmental cost reports, but they are not included in the cost of the product for valuation purposes.

Some problems of direct costing.—An accounting procedure with the advantages and usefulness described in Chapter III might give one the opinion that direct costing would dominate the field of cost accounting in a very short time. Gaining acceptance, however, has not been easy for this procedure. The problems encountered can be divided into two general groups. They are: (1) detail problems and shortcomings of direct costing and (2) problems of acceptability.

The first of the detailed problems of direct costing is the determination of fixed expenses. If a flexible budget is not used, the fixed expense must be calculated. Since management sometimes loosely classifies the fixed and variable expenses, it is desirable to reexamine both of these. As is usually the case it might be found that not all costs are absolutely fixed or exactly variable. Even in short periods, some cost items are semivariable and present problems even when changes are only from five to a six day week. Some techniques for determining fixed costs have naturally been advanced during recent years. The fixed portion of manufacturing
expense is approximated in some cases without making a
detailed study of the variability of each item of expense.
This is done by plotting the fixed cost at a number of out-
put levels on horizontal and vertical axis. A line is drawn
through the average position of the points to the vertical
axis. The point at which the line touches the vertical axis
approximates the fixed cost expense.

The following are some techniques for determining the
amount of fixed costs and therefore variable costs, including
the scatter diagram shown on the next page.

1. Management can scrutinize the chart of accounts
and can assign each account to the fixed or
variable group. If this is to be effective, the
chart of accounts must be very detailed and must
provide an object-of-expenditure classification.
'Cleaning supplies' and 'crane operator's wages
can be readily classified, but 'cleaning' and
'in-plant transportation' cannot. Another prob-
lem here is semi-variable costs. Perhaps the
ideal solution for this classification is a care-
fully drawn flexible budget, but this goes beyond
the simple scrutiny of a chart of accounts and
must be solved by method (2) or (3).

2. Statistical analysis of actual costs may be used
to determine the fixed and variable portion.
This may be done by making a scatter diagram,
and fitting a line to the points on it. A
scatter diagram is a chart on which observations
are plotted: . . .

3. Detailed study of the process and its cost may
be used to determine how much of each kind of
cost should be incurred at each volume. This
provides figures for a flexible budget, and, if
well done, gives a more accurate picture than
the scatter diagram. The latter represents a
kind of averaging process, and cannot take into
account special steps that would be taken at
different points, such as cancelling certain
insurance when a shutdown is made. While the
most reliable, it is also the most costly
ILLUSTRATION I

Scatter Diagram

Ulmart Co.
Spot-welding Department
Total costs in relation to volume per month
(except direct materials and direct labor)

Source:
method, and many firms get very useful information from the other method.

A second problem is the allocating of fixed costs to product lines. Under conventional or absorption costing, the fixed costs are a part of the product. Therefore, when the rates are applied to production, the fixed expense is automatically included. If standard cost is used, the variance must be allocated. This however is usually a small amount and the error, if any, would have a relatively insignificant effect on profit.

Under direct costing, only the variable costs are charged to the product and there is no basis of allocating the fixed cost. Methods such as using as a basis the total variable costs, or total direct labor have been used for convenience and simplicity. The use of such over-all basis for allocation may materially distort the cost of the products.

In variable costing, one danger is that product cost will be defined in such a way that it understates true cost variability. In direct costing, manufacturing overhead is not ignored; the variable portion of factory overhead is an integral part of variable product cost. Nevertheless, the behavior of overhead cost is exceedingly complex and there is a strong temptation to follow the line of least resistance and include in product cost only those costs that are obviously and fully variable. In some cases, the variable overhead has been excluded completely from product cost. This eliminates

1Vance, op. cit., pp. 428-29
some of the cost allocation problems, but it produces profit contribution data that may be grossly misleading.

To illustrate, assume that there are products with the following margins over direct labor and material costs:

<table>
<thead>
<tr>
<th></th>
<th>Product A</th>
<th>Product B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$4.50</td>
<td>$3.00</td>
</tr>
<tr>
<td>Standard prime cost</td>
<td>2.00</td>
<td>1.20</td>
</tr>
<tr>
<td>Margin</td>
<td>$2.50</td>
<td>$1.80</td>
</tr>
</tbody>
</table>

The above comparison would lead one to conclude that Product A is more profitable than Product B, at least on a per unit basis. But suppose that Product B requires very little processing and therefore the applicable factory overhead per unit is very small, whereas Product A is a relatively complex product, requiring substantial manufacturing effort (indicated by a high ratio of labor to material cost). For example, it might be that variable overhead cost on Product B is only $0.05 per unit, as opposed to $1.00 for Product A. A true marginal income comparison of the two products would thus show:

---

<table>
<thead>
<tr>
<th></th>
<th>Product A</th>
<th>Product B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$4.50</td>
<td>$3.00</td>
</tr>
<tr>
<td>Variable costs:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Labor and materials</td>
<td>2.00</td>
<td>1.20</td>
</tr>
<tr>
<td>Variable overhead</td>
<td>1.00</td>
<td>0.05</td>
</tr>
<tr>
<td>Marginal income</td>
<td>$1.50</td>
<td>$1.75(^1)</td>
</tr>
</tbody>
</table>

Thus, it can be seen that the true relative incremental profitability of the two products is just the reverse of earlier indications.

Even when proper consideration is given to overhead variability, the classification of fixed costs may be too broad, this is particularly true in the case of costs that vary in a discontinuous fashion in a series of steps. Such complex costs reactions require the exercise of judgement. If the steps are so spaced that a single step includes most of the probable operating range, the cost probably is correctly classified as fixed. If on the other hand, the steps are relatively close together, these costs should be classified as variable and the variable cost burden rate should be increased accordingly.

These considerations do not really constitute a disadvantage of the variable costing principle. Rather, they point up a danger that stems from

---

\(^1\)Ibid., p. 622.
misapplication of the principle. As such it must be recognized and guarded against, but it cannot be regarded as a serious object to the use of variable costing, appropriately constructed.

To avoid such problems as mentioned above, it is necessary that a separate allocation of the fixed expense be made to each production line. It is important that each production line carries its share of service operations expense. This should be made in relation to the normal volume of each product in each operation expressed in the term which best reflects activity. Some examples of a basis may be machine hours, direct labor costs, direct labor hours, etc. In some cases the allocation of the fixed costs to departments might not be necessary. A more equitable allocation may be secured by taking the costs directly to the products.

The third problem involved in the direct costing process is the determination of costs to be used for sales pricing. The lack of cost figures that provide a basis for long-range pricing has been considered among the most serious objections to the use of direct costing. The argument stems from the proposition that in the long run the price of a product must include both the variable costs and its share of fixed costs. It has long been recognized that simply adding a fixed mark-up to the variable costs will not provide satisfactory prices. The varying impact of fixed costs on the cost of a product as

\[\text{Ibid.}\]
a result of processing in different combinations of operations or from different processing speeds must be reflected for good over-all long-term results. With fixed expenses allocated to products, a satisfactory unit rate may be obtained by dividing the total by the normal sales activity units of each product. If there are individual items in the product line which are produced at different speeds, this however would not be true. For example, if in a carpet mill, the machine runs substantially slower when producing grade A carpets than when producing grade B carpets, this needs to be reflected in the cost and selling price of grade A carpets. In other words, since this causes a substantial variation in the fixed expense per square foot, it must be reflected in the sales price. Obviously, a pricing policy that did not take this into consideration could prove fatal.

In a situation such as the above, it may be necessary to develop expense rates by operations and then supply these rates to each product. This would solve the problem of increasing the fixed cost of grade A carpets, however, it would generally be necessary to reallocate the unabsorbed portion. Another possibility is to give a weight to each product and assign the fixed costs on that basis.

The above problems were classified as procedural problems incurred in the use of direct costing. That is to say, these are problems involved in converting to, using and applying costs when this method is used. The problems
involved in the second group are mostly ones of evaluation. They will be discussed in the remainder of this chapter.  

The effects of direct costing on the financial statements.--Financial statements as used here include the income statement and the balance sheet. Although it is understood that the primary objective of direct costing is the presentation of a more factual and a clearer picture of earnings, it does have an effect on the inventory valuation. It causes a reduction in the inventory valuation equivalent to the amount of the fixed costs excluded. Naturally, in some cases, this fixed cost is small. However, in other cases, the fixed costs constitute a material amount from both a dollar amount point of view as well as a relative point of view. This reduction in inventory is the major stumbling block preventing the general acceptance of direct costing by the two principle accounting organizations.  

What is the effect of direct costing on the income statement? The answer to this question does not depend upon the amount of fixed costs excluded from inventory as mentioned above. The income statement is affected adversely at the time of the change by a write-off of fixed costs included in inventory. In subsequent periods income on the direct and absorption costing bases will vary by the change in fixed costs in opening and closing absorption costing inventories.
### TABLE 3

#### OPERATING STATEMENT

**Absorption Costing Format**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less cost of sales</td>
<td>$80,000</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$20,000</td>
</tr>
<tr>
<td>Administration</td>
<td>$4,000</td>
</tr>
<tr>
<td>Selling</td>
<td>$6,000</td>
</tr>
<tr>
<td><strong>Total administrative and selling</strong></td>
<td><strong>$10,000</strong></td>
</tr>
<tr>
<td>Pretax profit</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

#### OPERATING STATEMENT

**Direct Costing Format**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net sales</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less variable costs</td>
<td></td>
</tr>
<tr>
<td>Material</td>
<td>$18,000</td>
</tr>
<tr>
<td>Direct labor</td>
<td>21,000</td>
</tr>
<tr>
<td>Variable overhead</td>
<td>21,000</td>
</tr>
<tr>
<td><strong>Total variable costs</strong></td>
<td><strong>$40,000</strong></td>
</tr>
<tr>
<td>Fixed costs</td>
<td></td>
</tr>
<tr>
<td>Manufacturing overhead</td>
<td>$20,000</td>
</tr>
<tr>
<td>Administration</td>
<td>4,000</td>
</tr>
<tr>
<td>Selling</td>
<td>6,000</td>
</tr>
<tr>
<td><strong>Total fixed costs</strong></td>
<td><strong>$30,000</strong></td>
</tr>
</tbody>
</table>

**Source:**

These two statements show how, with no change in ending inventory, the same amount of profit is indicated by both the absorption costing and direct costing methods. Dudick goes on to state:

Let us now consider some examples in which a variety of conditions is assumed. Table 4 shows a comparison of absorption accounting and direct costing with no inventory change; with an inventory increase; and with an inventory decrease. The composite results for the three periods are also shown. It also shows the sales, the cost of sales calculations, profits before application of period cost to the direct costing column, and the results after deduction of period costs. The absorption accounting figures are broken down into variable and fixed elements so comparisons can be made with the direct costing method. Note that the variable column under absorption accounting is exactly the same as under direct costing. Note in the second illustration (inventory increase) that although the $7,000 input of fixed costs is the same as the period cost appearing in the direct costing column, $4,000 of the $7,000 remains in the ending inventory, leaving only $3,000 of the $7,000 to be included in the cost of sales. The difference of $4,000 represents difference between profit of $10,000 under absorption accounting and $6,000 under direct costing.

The next illustration shows the results of an inventory decrease. Although the input of fixed costs is again $7,000 under absorption accounting, the same amount as the period cost to be taken against profit and loss under direct costing, there is an inventory decrease which releases $2,000 additional fixed costs into cost of sales. This $2,000 is the reconciling difference between the $3,000 loss under absorption accounting and the $1,000 under direct costing.

As mentioned above, the major characteristic of direct costing, so far as the balance sheet is concerned, is a reduced inventory value. Unlike in the case of the income statement, each year the amount of the understatement is the

---

### Table 4

Comparison of Profits Under Two Systems of Accounting

<table>
<thead>
<tr>
<th>NO INVENTORY CHANGE</th>
<th>Absorption Accounting</th>
<th>Direct Costing</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td></td>
<td>$18,000</td>
<td></td>
</tr>
<tr>
<td>LESS COST OF SALES:</td>
<td>$ --</td>
<td>$ --</td>
<td>$ --</td>
</tr>
<tr>
<td>Inventory-Beginning</td>
<td>$ 9,000</td>
<td>$ 9,000</td>
<td>$ --</td>
</tr>
<tr>
<td>Input</td>
<td>$ 7,000</td>
<td>$ 7,000</td>
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<td>Inventory-Ending (deduct)</td>
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<td>Inventory-Beginning</td>
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<tr>
<td>Period cost (deduct)</td>
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</tr>
<tr>
<td>Net Profit</td>
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Source: Ibid.
amount of fixed costs omitted from the ending inventory.

Because the amount of fixed cost excluded from the ending inventory will be small and hence not a significant matter for one company and, on the other hand, will be large and a significant amount in the case of another company, no specific statement about the balance sheet can be made. The best that can be said is that whatever fixed costs are excluded will effect adversely the total assets of the company, the working capital and the retained earnings. Advocates of direct costing have tried to justify direct costing on the bases that the only cost that is relevant and significant to inventory is the variable cost. They insist that this is the only thing that represents the savings of future costs inherent in the existence of a stock of goods. They further argue that inventory cost is really a cost deferral, rather than an inventory evaluation. Direct costs are the only costs that are incidental to the production of goods and hence the only costs to be included in inventories. Other manufacturing costs are simply costs of maintaining a readiness to produce. They point out further that fixed costs have no place in the process of income measurement since net income may be generated only by sales.

Although the above position and explanations are to some extent convincing, the criterion of accounting theory should not be discarded lightly. Tremendous progress has been made in accounting over the last few years; nevertheless, direct
costing has not gained over-all acceptance for external reporting. The following bears on this:

The use of direct costing for external reporting represents a different problem. Here we must be concerned with externally imposed requirements, as well as a different character of need for information. External reporting practices should be in accord with recognized accounting principles. They should fairly reflect income and provide reasonable asset valuations. Certified public accountants have attempted to develop a body of concepts and principles which best fulfills the need. Government regulatory bodies and the Internal Revenue Service have added some support by recognizing and insisting upon generally accepted accounting principles, at least in most respects.

All of these groups have given some indication of their unofficial attitudes toward direct costing. The balance of opinion at the present time is doubtless unfavorable toward its use for external reporting. Nevertheless, the nature of most of the pronouncements on the subject and, in some instances the lack of unanimity of support for them, leaves some reason for question as to acceptability or lack of it. There is still the possibility, therefore, of either acceptance or rejection when a ruling or opinion must be made. We must wait for the final answer on this score. It may not come soon, partly because of the difficulty of objectively and definitely defining product and period costs so as to give a clear and concise definition of direct costing. There can be little doubt that industry practice with regard to internal measurement of net income will have some effect upon the future of external acceptability of direct costing.¹

The effects of direct costing on the audit report.—

At the end of an accounting period, the accountant generally makes an examination. The examination is for the purpose of expressing an opinion on the financial statements. The opinion and accompanying financial statements are referred

to as the Audit Report.

What has been said earlier about the income statement and the balance sheet applies equally to the audit report. Certainly the audit report is an opinion on these same financial statements. As to what constitutes generally accepted accounting principles, it might be remembered that the phrase "generally accepted accounting principles" was adopted out of a recommendation by the committee on accounting procedure to revise the short-form audit report.

In an earlier quotation, direct costing was discussed in connection with external asset evaluation and income measurement. The author of that article pointed out that, it is not enough that a procedure be explained favorably or that certain isolated examples be given to justify the use of direct costing for external reporting. "Here, we must be concerned with externally exposed requirements as well as a different character of need for information."\(^1\) The author goes on to point out that external reporting practices should be in agreement with accepted accounting principles. The practice should fairly reflect income and provide an asset valuation that is reasonable. Moreover, we must look to the attitudes of practicing accountants, the accounting associations and government regulatory bodies, before we can conclude that direct costing is acceptable for external

\(^1\)Ibid.
reporting. As to the auditor's opinion on the use of direct costing in financial statements, a respected author in auditing stated the following:

Although the advocates of direct costing emphasize that it is primarily a means of cost control and only secondarily a method of inventory valuation, the result is nevertheless to produce inventory valuations for lower than under the traditional "full-cost" approach. Should the auditor lead his support to the use of direct costing in the financial statements distributed outside the company? For internal reports directed to management, direct costing may certainly be used if it provides more useful information as a basis for managerial decisions; the only issue from an audit standpoint concerns the use of direct costing in financial statements distributed outside the organization. Regardless of the merits which direct costing may possess for managerial purposes, its use for managerial purposes, its use for inventory valuation in the annual financial statements does not appear to meet the well established standard that inventories are to be stated at cost, including all the applicable expenditures incurred in bringing the goods to their existing conditions and locations. Exclusion of manufacturing overhead costs from inventory should prevent the auditor from expressing the opinion that the statements were prepared in conformity with generally accepted accounting principles.1

CHAPTER V

SUMMARY AND CONCLUSION

Uses of direct costing. -- Some accountants and the accounting organizations have reacted disapprovingly to the use of direct costing in financial reporting. Basically, the reason is that a part of the manufacturing overhead is excluded from product cost and asset valuation.

These same accountants are in general agreement that direct costing has real merits for management decisions. The basis of direct costing is the separation of costs into their fixed and variable components. This approach presents the information in a form needed for decision making, it provides better control through clear-cut responsibility accounting and it provides a good measure of income. Although the advocates of direct costing have not overcome the problems of acceptability, its usefulness to management is more than sufficient to justify a high rating.

The development of direct costing has served to give to management a divisional and product profit report presented in such a manner as to reflect the contribution of existing sales volume to fixed overhead and profit. The effects of increases and decreases in sales volume or changes in selling prices can be determined quickly and directly. Relevant data that are needed for decisions to change prices or to strive
for increased volume in certain product lines can obtained directly from records of prior periods without special studies and analyses. It is not necessary to make adjustments for changes in the degree of overhead absorption. Furthermore, the statements prepared from direct costing records are usually simpler and the use of technical terms is at a minimum.

Although those opposing direct costing sometimes argue that fixed manufacturing costs are ignored, to some extent, this method emphasizes fixed manufacturing costs. The aggregate amount of fixed cost to be covered can be easily observed from the profit product statement. This serves to dramatize the relative significance of fixed costs and also points out the effects of decisions which establish fixed costs. For example, suppose a product that has a high profit/volume ratio is being considered. A statement showing sales, and from this deducting the fixed and variable costs, will give the contribution margin (contribution margin means, sales less all costs except those arbitrarily allocated). A decision to expand the sales effort devoted to this product is likely to increase fixed costs. Statements prepared in accordance with the direct costing procedure show the effects of this increase directly and without confusion. When looking at the statement, the variable costs, marginal income and fixed costs are all separated and shown clearly. A comparison of the proposed level of sales, variable costs and fixed costs with the same items of the prior period points out the amount and results
of the change as it relates to variable costs and fixed costs. In contrast, this increment would be derived under absorption costing by first obtaining net profit margin and then adjusting this for differences in under- or over-absorption of fixed costs. As absorption costing works with full cost averages, the derivation of increments from such data can be extremely difficult.

Closely related to the above is the fact that under direct costing, the cost variability patterns are more readily apparent than under absorption costing. Under absorption costing, the variable cost data can be derived, however, it is true that direct costing makes it easier to get this information. Another advantage is that in direct costing, much of the work of identifying cost variability has already been done before the analyst gets the data with which he must work. Although there are some problems in classifying when using direct costing, this method permits the extraction of short-run variable costs directly from the records.

Another use to which direct costing is easily adaptable is cost control. This is an important managerial function in any business and can mean the difference between profitable and unprofitable operations. Costs are best controlled by means of budgets and periodic cost reports. Each budgeted item should be the responsibility of a definite person who will be expected to explain the variances to his supervisor. Flexible allowances cause budgets to reflect the realism of
operating conditions. A company using direct costing will find that it is easy to set up a flexible budget that defines the responsibility at each level of operations.

By use of direct costing, income figures are generated that fluctuate with changes in billings. Since fixed factory service costs are not deferred in inventories, but charged as costs of the period, and increase in billings will normally improve contributed margin and income. Although this does not actually solve any problems for management, since an increase in billings means an increase in margin and income, the use of direct costing allows one to know generally the income trends by observing billings.

Present and expected trends in direct costing.—It was mentioned earlier that accounting was not a natural inelastic science that stood still while business procedures, technical methods and industrial advances were taking place. In the last few decades, such changes as the acceptance of LIFO inventories and accelerated depreciation methods have been made and the over-all opinion is that results are better.

As is presently true in the case of direct costing, the above innovations met with opposition, and much was written to show the shortcomings and weaknesses of each. However, continuous and persistent efforts on the part of those in favor of such methods resulted in their gradual acceptance. Such a test now faces direct costing.

If direct costing is to be accepted, it must penetrate
the opposition of four influences. They are management, the American Institute of Certified Public Accountants, the Securities and Exchange Commission and the Internal Revenue Service. A further problem is that before one will accept something new, generally, there must be indications that the others will accept. The most likely route toward acceptance is that, if an increasing number of companies overcome their hesitancy and adopt direct costing for internal reporting, this will illustrate its operating usefulness and its theoretical soundness. When this is proven, it is probably that the Institute that will accept it. This would also be tantamount to acceptance by a number of independent public accountants since they will be working with and experiencing the results of direct costing. If the independent public accountants and the Institute give their indications of acceptance, it is probable that the others will follow.
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Books


Articles


**Special Studies**
