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Letters

L. A. Davis

COMMENTS

LETTERS

CRITICISMS

We feel the following letter, sent to Mr. Arthur Ottenstein, author of "Differential Cost Analysis," which appeared in our last issue, will prove of interest to all readers considering the adoption of direct costing.

THE EDITORS

Dear Mr. Ottenstein:

The article written by you appearing in March-April, 1966, MANAGEMENT SERVICES magazine is a very interesting article concerning a complicated yet very important aspect of accounting and financial analysis work. Congratulations on a fine article.

After reading the article, I am prompted to make two observations. One is that your explanations include some excellent reasons for direct costing. In our company direct costing has been used for many years. One of its important features is that cost elements are dealt with according to the manner in which they behave, that is fixed or variable, and much of the information which has to be obtained by means of a special study of the nature described in your article is available from the regular routine reports and analyses of variances. Furthermore, we don't have the problem of dealing with over- or underabsorbed fixed overheads. Another advantage is that we do not have the occasion to try to explain to nonaccountants why profits are down when sales are up.

L CORPORATION
DIFFERENTIAL COST ANALYSIS
NEW PRODUCT X
YEAR ENDING 12/31/—

Sales	400,000 units @ $.80			$320,000
Differential costs				
Direct material	400,000 units @ $.20		$80,000	
Direct labor	400,000 units @ .17		68,000	
Variable manufacturing overhead*	400,000 units @ .10		40,000	
Variable selling and general and administrative expenses*	400,000 units @ .05		20,000	208,000
				$112,000
Fixed manufacturing overhead				
Indirect labor		$15,000		
Depreciation		4,000		
Taxes and insurance		1,000	$20,000	
Fixed selling and general and administration expenses				
Selling salaries		$22,000		
Advertising and promotion		20,000		
Administrative salaries		4,000		
Interest expense		2,000	$48,000	68,000
Net contribution to fixed costs (before income taxes)				$ 44,000

*For purposes of the illustration the same rates for variable manufacturing overhead and variable selling and general and administrative expenses were used for the new product X as were previously determined for the company's regular operations. However, for any substantial change in productivity such rates may vary, depending upon the nature of the items included in these categories. It is, therefore, incumbent upon management to restudy the various accounts and determine any applicable rate change.

Mr. Ottenstein also pointed out that the indentation of "Fixed manufacturing overhead" and "Fixed selling and general and administration expenses" in Exhibit 3, page 61, in his article was incorrect. The report should have appeared as it does above.

Under a direct costing plan, product cost cards or sheets need only go through and include those costs which are variable. Thus we avoid the great amount of clerical effort in revising product cost when the level of activity or the rate of fixed overhead expenses changes.

We have been using direct cost for many years, and are completely sold on it. Should you be considering its adoption, we would recommend that you give it serious consideration because we think you will find great value in it.

The other observation is to suggest caution when incremental income is the justification to make a capital investment and expand the organization. The test of "Is It a Good Business to Be In?" should be applied, and a thorough examination of all alternates should be pursued. It does not seem very sound to take on a new product line which cannot pay its share of existing fixed expense and have a reasonable return on investment left over.

We find MANAGEMENT SERVICES an excellent periodical. Your article is a good example of why we like it.

L. A. DAVIS
Assistant Controller
Pittsburgh Plate Glass Company
Pittsburgh, Pa.