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*Direct costing as an accounting method has many valid uses but is dangerous when used as the main basis for product pricing decisions, the authors maintain. They argue, instead, for the use of an alternative good for the long run — full costing.*

## **DIRECT COSTING IN PRICING: A CRITICAL REAPPRAISAL**

*by Richard J. L. Herson and Ronald S. Hertz  
Hertz, Herson & Company*

**K**NOWLEDGE of how costs behave when there is expansion or contraction of sales or production is essential to understanding a business. The separation of costs into their fixed and variable components is the cost accounting technique normally used to provide this kind of information. Applications of such analysis to flexible budgeting and costing, breakeven analysis, and general cost control appropriately follow. Moreover, consideration of the variability or fixity of costs may even be an important element in

certain aspects of sound pricing decisions.

The concern here, however, is with the broadening of this approach, especially since World War II, to a general costing-pricing philosophy commonly referred to as direct costing and its application to major business decisions, particularly pricing. In general, it is the thesis of this article that a policy of using "direct" or variable costs as a basis for pricing and related decisions may at times lead to radically wrong decisions. The reason is that direct costing fails to

establish directly a basis for management to set standards of profitability that incorporate limitations of production capacity and appropriate allowance for risk.

### **Definitions**

The looseness of terminology that has developed in recent years makes it necessary to define our terms precisely. Direct costing is a method of cost accounting which charges against production only those costs that vary directly with the level of production; all remain-



The frantic balancing of "direct" costs against "fixed" costs as a means of establishing a final price can result in a product that loses money.

ing costs are charged to operations as they are incurred.<sup>1</sup>

Variable costs are those costs of materials, direct labor, and variable manufacturing, distribution, administrative, and financial overheads that fluctuate as production and/or sales change within existing capacity and within a specified operating period. Fixed costs are those which remain independent of fluctuations in volume of sales or production within the operating period unless there are changes in production, sales, administrative, or financial capacity.

Direct costs are costs incurred in particular cost centers or specifically applicable to a particular product; indirect costs are costs applicable to cost centers or products only by allocation.<sup>2</sup>

Full absorption costing (as advocated in this article) means the inclusion in cost of all elements of manufacturing, distribution, and administrative cost and also a provision, computed either directly or indirectly, for a minimum net profit. Total cost, as thus defined, becomes the minimum acceptable selling price, and the formulas

used for the absorption of all overheads, including the net profit element, are the "pricing discipline," a term we believe to be our own but generally applicable.<sup>3</sup>

Over a period of years we have seen the interchange of such terms as "marginal analysis," "breakeven



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analysis," "contribution analysis," and "direct costing." The various expressions have an underlying similarity of derivation in that they attempt to synthesize concepts and expressions found in cost accounting on the one hand and in economic theory (especially "marginal costs") on the other. Even if this synthesization were justified, it would not in itself be a valid reason for adopting a direct costing approach for the determination of profitability criteria. This "synthesization," however, is an oversimplification, the result, in our judgment, of an incomplete understanding of economic marginal analysis and the assumptions upon which it is based.<sup>4</sup>

### Value, selling price, and costs

While space is not available to examine in detail the theoretical bases of sound pricing policies, some general clarifying comments are necessary.

Regardless of the cost of a product to its manufacturer or seller, the price realized normally will not exceed its economic value. Once the product is brought to market, its economic value is the highest price the market will bear. In the case of goods that do not lend themselves to product differentiation, there frequently is a widely known price which, although it may fluctuate, is generally uniform throughout the market. In the case of products that lend themselves to product differentiation through such techniques as brand identification, styling, packaging, secret processes, and patent protection, the price is not established until the product is marketed.

### Projections of market value

It is a major function of management, crucial to business success, to anticipate the market value of products. Projections of market value are the result of management's skill; its understanding of the markets for its and competitive products; its knowledge of past and



current prices of comparable products already on the market; consultations with potential users of the product; and a general understanding, perhaps intuition, regarding value.

Cost does not determine selling price. However, in a well planned and well managed enterprise knowledge of cost is vital to sound pricing policy. Items that are not profitable on the basis of application of sound cost-selling-price criteria and cannot be "re-engineered" to fall within allowable cost levels may not be marketed. Thus, costing a product before it is offered for sale leads to the decision as to

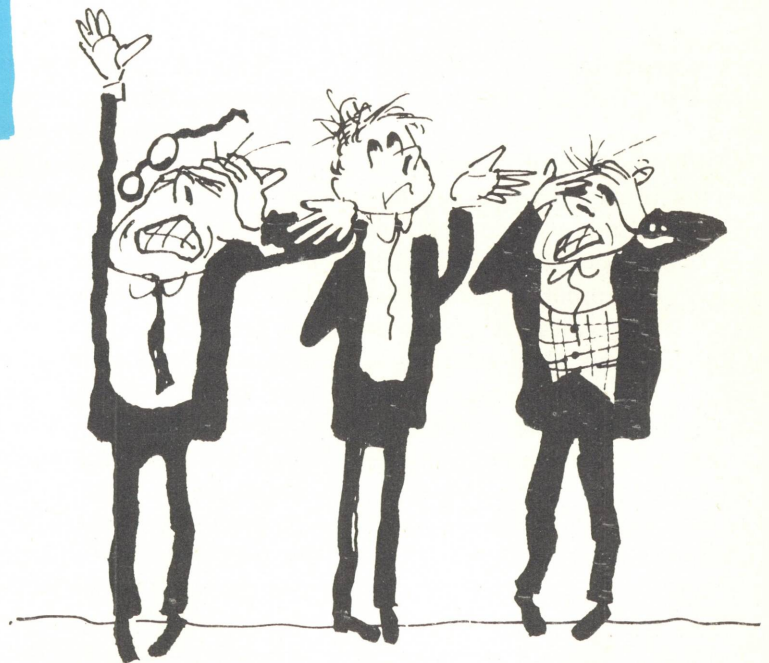
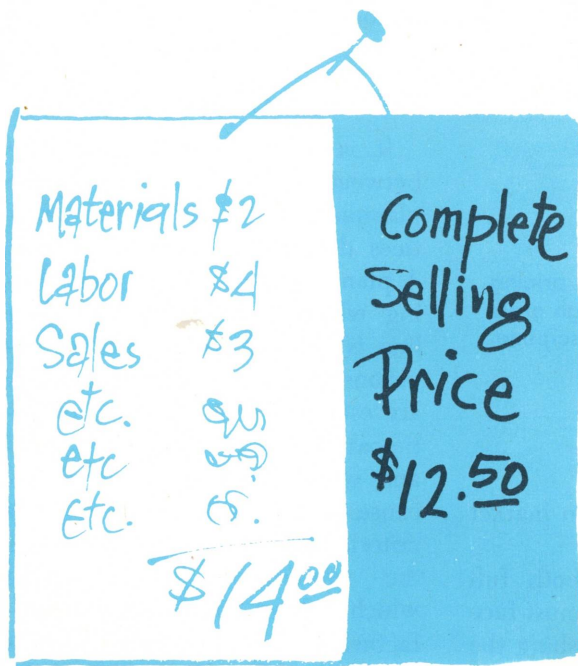
whether to offer it at the anticipated market price (as modified by such considerations as discount and/or freight terms, credit terms, advertising allowances, etc.) or discard it.

How does management determine pricing policies that will optimize the company's net profits? How does it systematically establish effective profitability criteria for selecting among alternative products and sales prices? How does it integrate profitability criteria with criteria for minimization of risk and maximization of use of production and distribution facilities? Effective refutation of the ap-

applicability of the direct costing concept requires a systematic analysis comparing it with an alternative, full costing.

**Pricing discipline and full cost**

Profit planning is essential to business success, and pricing discipline is essential for proper profit planning. Even direct costers must realize—at least intuitively—that a minute contribution margin is unsatisfactory. Without a minimum standard for profitability, management may be tempted to feel that since some profit is better than none at all any selling price that exceeds



Costing a product before it is offered leads to the decision as to whether to offer it at an anticipated market price or discard it entirely.

establishing minimum profit margins compatible with limitations in capacities. Direct costers may appear to solve this problem during the planning period by determining combinations of products, prices, and distribution methods whose sales and contribution margins relative to total fixed costs appear to be maximized. However, there is a considerable risk in assuming that the planned mix of products, prices, distribution, production methods, etc. will be maintained during the operating period and that fixed and variable costs computed on "static" assumptions will behave as defined during the subsequent dynamic operating period.



To establish standards of minimum profitability, a group of pricing formulas must be evolved that work back from net profit through gross profit to the selling price. This has been termed the pricing discipline.

### *Projection of planned mixes*

It is important to differentiate between pricing policy during the planning period and pricing practices during the operating period. A planning period is the time during which a product or product line is readied for sale—when revisions are made and offering prices are established on the basis of anticipated market values and costs and when items are rejected because of their failure to meet profit criteria. The operating period is the subsequent period during which selling, purchasing, manufacturing, and distributing operations take place. In practice, the time periods can overlap. Functionally, in the decision making process, there is a separation.

During the planning period under a system of direct costing, alternative combinations of products, prices, volumes, and costs are projected to determine the product-distribution mix that maximizes total contribution. The accuracy of the final projection depends, of course, on the accuracy of the projected demand schedule of each product (the quantity demanded at a price which in turn depends on the assumed price elasticity); the compatibility of the demand schedule with capacity; and the projected behavior of wage rates,

“direct cost” is acceptable, or it may gamble on averages, assuming that less profitable sales will be offset by those that are highly profitable.

In order to establish standards of minimum profitability, pricing formulas must be evolved that, in effect, work back from net profit through gross profit or gross margin to selling price. A group of pricing formulas that establish a minimum standard of gross profit or gross margin when applied to the pricing of particular products has been termed the pricing discipline. In the establishment of a pricing discipline adequate allowance must be made, of course, for all costs and expenses, including the potential losses from off-price sales resulting from quality deficiencies and obsolescence. The pricing discipline is used only to set minimum selling prices: actual

selling prices are based on market value.

It would seem that both full costers and direct costers must face the same problem, establishing the minimum gross profit or gross margin. The full coster includes in his formula an adequate allowance for fixed as well as for indirect variable costs, which are costed into the product at a pre-set level of production and sales. And the direct costers? Among the criteria suggested by the more sophisticated are the relationship of the contribution margin to the capital employed by a particular product line and the relative proportions of material and conversion cost, including relative machine hours.<sup>5</sup> (Shades of “orthodox” full cost allocation?)

Thus, full costers solve directly what direct costers must solve indirectly, that is, the problem of

material prices, overhead costs, and other costs. The projection will be modified by such practical operating considerations as the extent to which interchangeability of materials, labor, equipment, etc., can be used to reduce risk; the size of the product line; the number of stockkeeping units; machine set-up time and flexibility in use from product to product; production lot size; company market objectives; and general company policies and history.

Such assumptions as the planned product-distribution mix and the extrapolation into the future of past functional relationships must be followed to their effects before the projection may be considered ready for application. A change in almost any projected factor can adversely affect the total planned contribution—if minimum markups and capacity factors are considered

in total rather than on a product by product basis. The uncertainty of all forecasts is the essence of the problem in determining a pricing discipline.

Based upon his projections, the direct coster may compute mathematically a policy that appears to maximize profits. The use of computers and techniques of linear programming can make "dynamic" projections of price-product-customer-distribution mixes within the appropriate limitations of productive capacity, available financing, etc. But what happens if there is a shift in demand, an error in the projection, a change in the mix? And with what omniscience must the planner project so that changes in the assumptions underlying the very separation of fixed and variable expenses (as elaborated in the section to follow) will have no material effect? The non-quantifi-

able elements of business appear; the future is uncertain. This is the gamble. The question becomes one of contribution costing's potentially higher projected profit versus full costing's reasonable realizable profit. Conceptually, computer runs can simulate many of the assumptions of direct costing, but it is management that must evaluate the risk as well as all the intangibles of customer relationships, market conditions from the demand and supply side, and organizational and historical factors. The use of full allocation costing with a price discipline is the logical alternative, reducing the dependency upon the accuracy of projections.

Of course, the full coster runs some of the same risks in the use of projections and in the setting of levels for the absorption of costs. It must not be inferred that budgets, planning, and projections—



A misdirected emphasis on volume instead of profitability can be destructive to a business since it leads to preoccupation with uneconomical products.

assumptions about the future—are not essential in full costing. However, the allocation of all costs to the product minimizes the speculative factor resulting from changes in the basic assumptions in the projection. The same criteria have been applied in all pricing decisions for all sales so that the sales dollar, if not homogeneous throughout, is at least a common denominator. This is true, regardless of the product.

The full coster must take a stand on the allocation of overhead that the direct coster is not required to do during the planning period. Accordingly, contribution costing may permit the introduction of products into a company's product line that would not qualify for production under a full costing policy. In this way, contribution costing may in some circumstances provide an opportunity for larger volume and greater plant utilization. This very approach, however, with its misdirected emphasis on volume instead of profitability, can be destructive to a business as the plant and management capacity become occupied with uneconomical products and as overhead, both factory and distribution, is expanded to meet each of the new capacity requirements.

#### **Cost separation**

The risk of changes in product mix and other factors during the operating period is not the only danger threatening the user of direct costing for pricing decisions. There is also risk of changes in the nature of fixed and variable costs. A cost is fixed only in the short run; over the long run all costs are variable. Thus fixed and variable cost separation, like the breakeven analysis of which it is a basic tool, is essentially a static technique. Variable data must be available, but the informed decision maker will recognize the real variability of all costs when he allocates to products depreciation by machine hours, office costs by paper work, production overhead by size of lot and set-up

time, and warehousing by handling costs and method of shipment. In an economy of large investments in equipment, shortages of labor, and uncertainty, direct costing loses much of its pragmatic justification.

Breakeven analysis—of which direct costing is historically an extension rather than vice versa—portrays the short-run relationship of costs, revenue, and profits as a function of activity. It is based on a projection of a myriad of assumptions about product mix, distribution mix, selling prices, direct costs of manufacture (wage rates, material prices, efficiency, etc.), distribution and selling expenses, overheads, and the like. In effect, quantities, prices, costs, markets, salesmen, overheads, etc., are all projected.

Assumptions about product mix, prices, inventory level, lot size of production, markets and methods of distribution, uses of equipment, etc., are all basic to the analysis of fixed and variable costs. If the assumptions hold, fixed and variable expenses will behave as they are supposed to—but even then only over a limited range of output, certainly not over the entire potential range. With theoretically constant mixes for prices, products, and distribution, the standard graph of one horizontal line for fixed costs and one linear curve for variable costs does not apply to the entire range of output from zero to existing capacity and certainly not to future time periods and capacity changes. Thus, assumptions about time, expectations, the particular range of output, and the variations of expected change can be applied only within relatively narrow limits. For example, certain indirect labor may be treated as fixed at a 60 per cent capacity level of output but can become largely variable at 80 per cent. Equipment needed on an hourly rental at 60 per cent may become by purchase a fixed cost at 80 per cent. In general, fixed costs tend to become variable as output and sales increase, while variable costs may tend to become fixed as output and sales contract. Salesmen on salary plus incentive

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on sales increments can be fixed at 60 per cent and partially variable above 80 per cent when the incentive level is reached; and salesmen on drawing against commission are relatively fixed for the immediate period until their commissions exceed their drawing accounts.

The segregation of costs into their fixed and variable components depends on the planned level of operations and estimated capacity (adjusted for normal seasonal fluctuations where necessary). The costs that are fixed at the planned level would not be the same if the planned level were significantly reduced or increased (even where significant idle capacity exists). Variable costs for increments in output from a zero base are not the same as from a 40, 60, or 80 per cent base.

Extrapolations into new ranges of operating levels or new time periods must take into account equipment needs, overtime requirements, risk in off-season inventory accumulation, available outside production facilities, production lot size, etc. Apparent excess capacity ceases to be excess when longer manufacturing hours are required. Changes in sales mix lead to inefficiencies in the use of existing facilities; new products create a need to expand supervision and administration as well as variable production costs. The fixed costs of equipment and general administrative expense become variable—particularly with “underpriced” products. The pat assumption that only a few expenses, such as power and supplies in the factory and freight and salesmen for distribution, are variable is shattered by reality. The opportunity cost as well as the allocable cost of management that is not priced into the product becomes significant, especially if disproportionate amounts of time are diverted to products and customers where cost has been computed without regard to “fixed” costs. Even the fixity of depreciation cost beyond the immediate planning period is a mirage with ever increasing mechani-

zation and with operations currently running at full capacity.

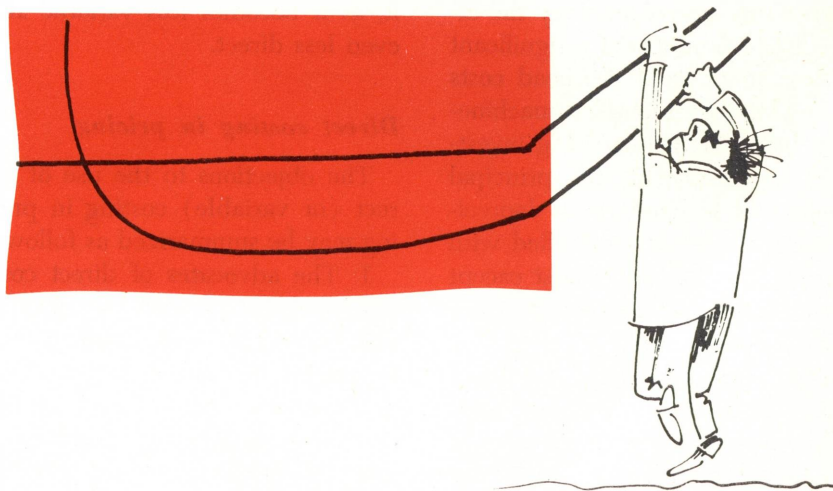
### Allocations

Allocations of indirect costs to products under full absorption costing may be subjective and unreliable, the direct costers argue. Yet the assignment of variable costs to products under direct costing may be equally arbitrary, where such costs are indirect and therefore not readily identifiable with specific products. Variable distribution expense components that are not directly assignable to specific products, for example, are generally allocated on the same basis as their fixed components. The example of the sales force with guaranteed drawing accounts applies again here. Only after drawings are exceeded by commission earnings does part of such sales compensation become variable. For which salesman and group of salesmen it becomes variable depends first on the assumed operating levels and then on the mix of salesmen. These, in turn, depend in part on customer, product, and

style mixes. To which product or item sold do the recurring unearned commissions apply? Or are they not a cost until sales levels are reached where all are variable?

The same applies to administrative and financial overheads, whose variable components are usually allocated on the same basis as their fixed components after deduction of the assignable and/or identifiable expenses of the product group or division. The allocation of general and administrative costs, when attempted on a “logical” basis rather than by arbitrary proration, is a problem primarily of determining functional relationships, not of separating fixed and variable costs. Thus, for allocation of clerical costs to a product grouping, the determination of the average size of the invoice, the frequency of back ordering, the number and size of customers, and the number of lines per invoice is more significant than the fixed and variable separation of clerical labor costs.

What about such variable plant overhead expenses as parts, power, supplies, etc.? How do product costs reflect such expenses? Are



Even with theoretically constant mixes for prices, products, and distribution, the standard graph of one horizontal line for fixed costs and one linear curve for variable costs does not apply to the entire range of output.





Direct costing may lead to the underpricing of some products and relative overpricing of others, by omitting fixed or capacity costs.

they not first allocated to a cost center, direct and/or service, and then prorated to the product on a machine-hour, labor-hour, or labor-dollar base? Is this identification of variable expenses any more direct than most fixed overhead? Under today's machine technology the allocation to products of a significant proportion of fixed overhead costs is on a directly identified machine-hour basis. With increasing investment in equipment, the principal component of fixed costs, depreciation, is as directly identified with a product as any other cost except direct materials—and perhaps more readily determinable.

Even the allocation of direct labor (theoretically, a "pure" variable) to the product is often indirect, as a function of machine-hour cost. What is direct labor when rates of output are machine-determined? Is there any difference between direct labor and indirect labor when a crew is employed,

e.g., supervisor, engineer, and materials handlers as well as machine operators? With the obvious trend away from hand work to predominantly machine work, direct labor more and more takes on characteristics traditionally not ascribed to it, as it becomes less variable and even less direct.

#### *Direct costing in pricing*

The objections to the use of direct (or variable) costing in pricing may be summarized as follows:

1. The advocates of direct costing have taken a useful accounting and analytical tool, namely, the separation of costs into their fixed and variable components within existing capacity, and extended it into a point of view which in effect assumes that many costs are fixed in the long run, failing to recognize the myriad of short-run assumptions in the original separation.

2. A pricing policy based on direct costing is unrealistic because it does not directly establish a minimum profit margin which can be used by management for comparison of the relative profitability of products and which provides for the cost of capacity expansion.

3. By omitting fixed or capacity costs, direct costing may lead to the underpricing of some products and relative overpricing of others, creating shifts in demand in favor of the less profitable product mix.

4. The theoretical model of direct costing must assume the accuracy of projected demand schedules; product, customer, and distribution mixes; and accordingly of consequent cost behavior, assumptions that are unduly speculative.

5. If fixed costs are not allocated, a pricing policy that seems logical in the short run may become ruinous in the longer run as fixed costs become variable. And fixed costs may become variable

when plant capacity that is fixed in the planning period becomes variable in the subsequent operating period precisely because of its use for production of "underpriced" product lines. When shifts in mixes require changes in production, distribution, and/or administration, overheads must become variable because of significant expansion of output.

6. There is a notion that variable costing is simple and accurate while allocation costing is complicated and distorted. This has been demonstrated to be erroneous. Furthermore, while effective costing for a pricing discipline depends in part on the validity of functional allocations on the one hand, it de-emphasizes the accuracy of the fixed and variable segregation of expenses on the other.

#### *Appropriate applications*

Direct or variable costing provides important information for management. Among its uses are the following:

1. Control of operations by means of flexible budgeting and/or standard costs and analysis of budget variances and variances from standard during the operating period

2. Breakeven analysis during a planning period as an overall guide to management in forecasting

3. Feasibility analysis where it is necessary to forecast the effects of alternative management decisions such as price, cost, or volume changes upon profits

4. Assistance in determining the advisability of special pricing, inventory holding or replenishment, and other ad hoc decisions during the operating period: However, use

of variable costing in such circumstances is limited, as has been implied previously in this article; it is essential that, for example, basic pre-operating-period planning not be superseded by ad hoc contribution thinking.

5. As supplementary information for management in its judgment of the propriety of fixed cost allocations made under the full absorption costing approach: The recognition by the decision maker of large fixed cost allocations against products, decisions, etc., with high contribution margins may well lead to corrections in the assumptions made by cost accountants where market factors, availability of similar services from outside sources, etc., may not have been given consideration.

In these cases and for other specific analytical projects designed to yield special information for management, fixed costs may be temporarily held in abeyance. But in the operations of the business, regardless of method or time, ultimately they must be paid for and accordingly reimbursed, in effect, by the customer through inclusion in the price of the product.

Furthermore, full costing, by definition includes opportunity costs, the alternative uses of men and facilities—those involved in production as well as those involved in administrative and in overall management. Perhaps the inclusion of opportunity costs is the primary function of full allocation costing and disciplined pricing. Conversely, it is probably fair to say that if there were no opportunity costs, no alternative uses of men and facilities, full costing might be irrelevant. But then so would the study of economics itself!

*The theoretical model of direct costing must assume the accuracy of projected demand schedules; product customer and distribution mixes; and accordingly, of consequent cost behavior, assumptions that are unduly speculative.*

#### FOOTNOTES

<sup>1</sup> "Analytical Methods of Measuring Marketing Profitability: A Matrix Approach" by Frank H. Mossman and Malcolm L. Worrell, Jr., *Business Topics*, August, 1966, p. 36.

<sup>2</sup> From the literature of "direct costing" it would seem that its proponents actually mean "variable costing," i.e., costing into the product those costs or components of costs that tend to be sensitive in the

short run to rises and falls in production— for which the term “variable” has traditionally been used in cost accounting.

The term “direct costs,” on the other hand, has traditionally been used to define costs specifically attributable to a particular cost center, department, or product line with no implication that such costs are necessarily variable. Raw materials are, of course, both direct and variable costs; frequently, perhaps usually, direct labor is the same. But some direct labor and direct manufacturing overhead applicable to the production cost centers, for example, may well be fixed in the accounting sense. For example, the foreman of a cost center or even a highly skilled machine operator with a skill that is difficult to replace may be employed on virtually a fixed salary basis even though his work is a direct cost.

The term “indirect costs” is meaningful only in context; for example, costs that are direct from the point of view of a service center are indirect from the point of view of a cost center or product to which the aggregate of such service center costs is applied. From this point of view, both direct and indirect costs may be either fixed or variable, depending on their behavior relative to production or sales. While the term “variable costing” may be more appropriate, for this article the currently used term “direct costing” is used.

<sup>3</sup> The computation of full cost consists of measuring the direct variable product costs, absorbing variable and fixed manufacturing overhead by formula, then marking up the total product cost by one or several formulas to arrive at a minimum required realizable net selling price, and, finally, adjusting this price by formula for potential losses from off-price sales resulting from quality deficiencies, obsolescence, etc.

A full description of the techniques for the development of the several formulas is beyond the scope of this article. Briefly, however, the main elements in addition to the measurement of direct variable costs (materials and variable direct labor), include, where applicable, the following:

1. Selection of the appropriate independent variable of which manufacturing overhead may be considered a function—direct labor dollars or hours, machine hours, direct unit output, etc.—and computing a flexible tabulation of this independent variable as a function of levels of output

2. Preparation of flexible manufacturing and distribution-administration overhead tabulations with variables in the former case expressed as a function of the independent variable described above

and in the latter as a function of production and/or sales

3. Additions to both overhead categories of an element of profit, if this approach is to be taken

4. Selection of absorption levels relative to both categories of overhead (a decision that will be partially influenced by whether a net profit factor has been included as indicated in 3 above).

This selection is the crucial point in absorption costing. If net profit has not been included directly, then a wider safety margin between capacity and absorption levels must be considered, indirectly providing for profit through planned overabsorption. This has been dubbed “comfort margin,” again our own term but one with broad usefulness. The measurement of capacity must also consider seasonal fluctuations, availability and flexibility of all the relevant factors of production, and the position of the company in comparison with its industry relative to its technological development, flexibility in employment, and the ability to eliminate the factors of production, competition, etc.

<sup>4</sup> When accountants jump upon the interdisciplinary bandwagon, however, they should understand the fundamental concepts of what they are borrowing. To the late Nineteenth and early Twentieth Century economist, marginal cost and marginal revenue were terms used to describe the rational relationships among the firm, the factors of production, and the market. These traditional economic models were derived from *a priori* logically founded definitions of behavior. The cost and demand functions were presupposed for the determination of price and level of output by a rational entrepreneur whose very rationality was defined by maximization of profit. This model, is, in effect, an analytic proposition, and for an analytic proposition the basic realities in the computations of the curves—the motives of profit maximization, the objectivity of calculations, the reliability of estimates—are all irrelevant. To be pertinent to management decision making, however, marginal analysis must take into account such “irrelevancies” as the applicability of statistically derived demand and supply curves in the light of knowledge of cost curves; the reliability of estimates of demand and price elasticity; the extrapolation of data and expectations; the interrelationship of selling costs, changes in quantities demanded, and overhead costs; the basic immediate goal of profit maximization versus such longer-run business considerations as liquidity and risk minimization; and effects on relationships with customers, suppliers, competitors, the

public, unions, etc.—in general, the position of the multi-product firm in a multi-process technology.

<sup>5</sup> NAA Research Report 37, “Current Applications of Direct Costing,” National Association of Accountants, New York, 1961, pp. 44-53.

<sup>6</sup> Direct costing emerged during the 1930's. It is ironic that it is more popular now, in a period of prosperity, capacity utilization, and expansion even outwardly ill suited to many of its underlying assumptions. Depression period ad hoc business thinking logically was influenced by the existence of idle capacity of plant, equipment, and labor. At least 15 per cent of the work force was usually unemployed; furthermore, labor unions had not yet reached their present strength, and employers had greater flexibility in hiring, layoffs, setting standards, cost control, etc. Fewer capital assets were committed to each worker, and, from the point of view of the individual enterprise, insolvencies and quick changes in ownership of capital assets at distress prices had decreased dollar costs of investment per worker below the years immediately preceding. Brand identifications, markets, and selling prices were less differentiated, on the whole, and in many more markets than today intense price competition prevailed.

Compare our current economic situation: little idle capacity in manpower or machines, a high and increasing ratio of machinery to labor cost, powerful trade unions, more restrictive labor laws and relatively inflexible labor costs, and rising costs of fixed asset replacement and management and administrative personnel.

The special characteristics of the depression economy made it possible for management to emphasize variable costs and frequently neglect fixed costs in pricing decisions without apparent adverse consequences. In an economy of idle capacity, incremental costs tend to be small, and certain costs may not increase at all until capacity is absorbed. Graphically, the fixed cost plateaus were much longer relative to the existing operating levels of many businesses. However, as plant and equipment were replaced and as capacity was fully utilized on regular product lines, costs that appeared to be constant eventually became variable. Continuing an ostensibly “logical” short-run policy into the long run would have been highly destructive.

The peculiar problems of the depression gave direct costing a pragmatic justification that obscured its theoretical fallacies. The continuation—and even expansion—of the concept to a changed economic and technical environment is an excellent example of a cultural lag.