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## “No Sales Below Cost”

BY WARREN W. NISSLEY

Now that the national recovery administration and the act which created it have passed into history there is an inclination to regard the whole adventure as a closed incident—merely a costly experiment which failed. Since, however, there are already reports of attempts to revive it, we would do well to see if there are not lessons to be remembered and experiences of which we well may take advantage if this method of economic control is again brought forward.

One of the underlying theories of that portion of the “new deal” which embraced N. R. A. was that all would be well if everyone deserving of employment were employed and, in addition, were paid a fair wage. Inasmuch as the conditions with which we were faced were very different from this ideal—and few intelligent persons would deny that it would be ideal—it is not surprising that the code makers were attracted by the theory. But they made a common mistake in attempting to use the end desired as the means of arriving at that end. As a result, trade and industry were given, as the law of the land, codes which put definite limitations on the minimum wages to be paid to employees and the hours they could work, and, in many cases, the hours during which machinery could be operated were also limited.

While business leaders endorsed the primary economic object of the codes, which was to have industry voluntarily agree to employ more people and thus alleviate unemployment, and to pay more aggregate wages for the same work, thus increasing the purchasing power of the masses and promoting recovery from the depression, it was quite natural that they should ask, to use a slang expression, “What will we use for money?” From the financial and accounting viewpoint, it is obvious that an employer can only pay wages out of the sales price of his goods or out of the working-capital portion of his capital funds. As a practical matter, at any given time, he can pay them only out of the cash he has in hand. It is obvious, for example, that a great corporation can not use any portion of its huge capital investments in plant and equipment nor even its inventories and accounts receivable to pay wages.

The working capital of many employers had been depleted almost to the vanishing point by the depression years. Cash operating losses, including wages, had been met by paying out cash realized from the partial liquidation of other working-capital assets. This liquidation was possible because smaller quantities of goods could be carried in stock and at a lower cost per unit; and open accounts with customers were also less because of the reduced volume of business. It was only this partial liquidation that enabled many concerns to avoid the necessity of going into bankruptcy during the first few of the depression years. The recovery, which has already begun, will again involve larger working capital investments in inventories and receivables which must be paid for from cash on hand or new borrowings. Consequently, even if those employers who still had cash resources had been altruistic enough to consent to dissipate them more rapidly on a voluntary basis, it would have appeared most imprudent from the business standpoint to have asked them to increase cash losses to pay higher wages. Such a policy could only end in going out of business at a faster rate, and then there would be no employment. The only cash from which the wages of the country can safely be paid in a period of rising prices and increasing activity is that represented by the proceeds of the current sale of goods.

The code makers then adopted a second theory to the effect that, if all units in an industry were required to sell their goods for cost or more, the problem of providing money to pay wages would have been met. Here again, the end desired was used as the means, and many codes were adopted which prohibited "sales below cost." Business leaders then asked, quite naturally, how goods could be sold at such an arbitrary price if it was so high that the consumers would not pay it, or if some other producer could sell at less under the code, because his cost was less. The latter part of this problem also involved a definition of "cost," since very few codes specifically defined the term which, by law, was the bottom below which selling prices could not drop. Many employers were already selling goods at less than cost under the old wage scales because no markets were available at higher prices and the adoption of codes did not provide any additional markets. Some attempts were made, without much success, to have codes approved which would, in effect, have guaranteed a profit by law.

While many of the codes which were approved that contained some form of prohibition of sales below cost also contained a requirement for the development of a uniform method of cost finding to enable the units in the respective industries to determine their costs on a uniform basis, many of them did not. When an attempt was made to define cost, the language used for these provisions, and the meaning thereof, differed widely in the various codes. The theory most favored by N. R. A. appeared to be that no unit in an industry should be permitted to sell below its own individual cost, unless necessary to meet the competition of another unit which was selling below the first unit's cost but not below its own cost. To meet such competition, the minimum price permitted to the higher cost producer was that quoted by the other. But since, in most cases, cost was not defined, this theory could not be enforced in practice and the effect was, of necessity, largely psychological.

Now let us consider what these provisions meant.

To the casual reader, a legal prohibition against sales below cost appears simple and innocuous enough—in fact, many would think that anyone who needed a law to prevent his selling below cost should have his brain examined. But this theory is not nearly as simple—nor perhaps as innocuous—as it seems.

It will help us to understand the necessity for some provision of this kind if we consider the chaotic condition of our price structure during the depression, and then examine its cause. The fundamental cause was our excess capacity to produce and to do practically everything, on the basis of the demand then existing, and in many cases, on the basis of any potential demand.

In passing, I might refer to the belief of many economists that there can never be real overcapacity while anyone lacks anything he would like to have, and to their contention that the whole trouble with our economic system is in the distribution of the things produced. It seems to me that this is true only to a limited extent. It fails to take into account the fact that, in any form of society, those men whose toil has been rewarded with the things they want are apt to desire to reduce the amount of their toil rather than to continue working to supply the drones with the things the latter are too lazy to produce for themselves. This simply means that it is possible to have excess capacity and supplies while there is still want, because those in want will not work. At the present time, there is also need for things we have the

capacity to produce because those needing these things can not find employment, and that is a defect of our distribution system.

The effect of this overcapacity on prices may be shown by referring to cost accounting. The expenses incurred in producing an article were originally classified by cost accountants in three groups: (1) the cost of the materials contained therein, known as direct materials, (2) the wages paid to the workmen who actually worked on the article directly or through a machine, known as direct labor, and (3) the other expenses of operating the plant, commonly known as overhead.

Under later developments of the art, cost accountants also made another classification of operating expenses to show: (1) the total cost of producing any article made and (2) the cost to the organization if it produced a certain article, which it would not have to meet if that article were not produced—i. e., the out-of-pocket cost.

The difference between the "total cost" and the "out-of-pocket cost" represents the so-called invariable overhead. This difference may be very important in large industrial units. When an organization is able to sell as much as it can produce, it is concerned with the first, or total cost, of each article sold and naturally bases its selling prices on that cost, since that is the only method of getting a profit. But when it is producing and selling at much less than capacity, sales based on "out-of-pocket" costs can assume a peculiar significance as a means of reducing losses. For example, consider a company which can produce 500,000 units of an article in a year but, at a given time, is only producing at the rate of 100,000 units a year and has a total cost of doing business on that basis of \$1,000,000 per annum. The total cost of producing each article is then \$1,000,000 divided by 100,000, or \$10 each. Now let us assume further that of the \$1,000,000 total cost of doing business, \$400,000 represented taxes, insurance, rent, depreciation, unavoidable maintenance, salaries of the essential non-operating personnel which can not be discharged without going out of business permanently, and similar expenses which would be just the same whether the plant operated or not, in other words, the unavoidable overhead. We see then that the remainder of \$600,000 represents the expense the company had because it produced the 100,000 articles in excess of the expense it would have had if it had produced nothing. On that basis, the out-of-pocket cost of each article was \$6.

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It seems quite logical for a particular management to feel that if it can sell these articles at \$8 each, it is better than not operating, even though it realizes that if that policy is continued long enough, it will put the concern out of business, because of the losses incurred in paying out cash for the invariable overhead expenses. If each unit in the industry produced no more than its own share of the total production of the industry, and if the price of \$8 which was obtained was uniform for all and was the highest possible price that could be obtained for that industry's products under existing conditions, such a policy could be economically justifiable even though sales were made below total cost. But uses have been made of this spread between total cost and out-of-pocket costs that are not justifiable from the viewpoint of the industry as a whole.

During the depression many managements looked with longing eyes at their idle capacity, such as that in our example, which could produce 400,000 more units, and reasoned that if they could get some of the business that would normally go to another producer, by quoting a price of \$7 for it, they would still be \$1 per unit better off than if they did not get the additional business at all; and they would also be able to distribute the out-of-pocket labor cost to their own workmen. It was the policy of taking business on that basis, sometimes called predatory price cutting, that caused the final collapse of the price structure. In self-defense, the unit that lost the business had to try to regain it or other similar business from someone else, by cutting prices still further, until finally the whole industry would be selling at or near the out-of-pocket cost of \$6 per unit. In fact, those concerns which did not have good cost systems frequently met the competition by going below \$6 since they did not know what their out-of-pocket costs were. To attempt to protect their dwindling cash resources resulting from this policy, producers had no alternative but to reduce their expenses, including wages. But then the whole vicious circle started over again. It is not difficult to see how easy it was for purchasers to develop a buyer's market under these conditions.

It must be admitted that good cost accounting systems and an accurate knowledge of costs on the part of some units at least in an industry actually accelerated this process, because it could be accurately shown that for a single unit, and for the moment, results were improved by taking business on that basis. But the

advantage gained could only be temporary. One can easily correct ignorant selling below out-of-pocket costs, because it is possible to show that is silly. It simply means there is less cash in the till after the transaction is completed than there was before. That can be corrected by adequate systems of cost finding and by education. Sales deliberately made at an out-of-pocket loss by a strong unit, which can afford to suffer the loss temporarily, to drive a weaker competitor out of business, are another matter. These are criminal activities and should be corrected by punishment through legal methods.

When we consider sales made at prices falling in the twilight zone between total costs and out-of-pocket costs, we are faced with important business and economic considerations that are not so readily answerable.

An expression frequently used in codes prohibited sales below the "cost of production." I assume that "cost of production" thus used was intended to mean out-of-pocket costs as I have defined them. A lower limit, such as that for an industry based on the costs of the lowest-cost producer, means exactly nothing in the way of protection for the industry. Other codes specified the items to be included in calculating costs, and when you had taken them all in, you had approximately "total cost."

There is no doubt that a prohibition of sales below total cost would be an effective method of enabling all the present business units to stay in business and continue to be able to pay wages, if consumers had sufficient purchasing power to fill their requirements at prices calculated on that basis. In view of our present excess industrial capacity, it is probable that any minimum cost prescribed for an industry would be the cost at which the products of that industry would be sold. For if "total costs" are used as a minimum, even if they are the "total costs" of the "low cost" units or of the "efficient producers," they will enable most of the high cost producers to stagger along hoping that more demand will develop and that "supply" will again become a factor in establishing the price structure on a basis that will enable low-cost producers to make a profit and high-cost producers to break even.

Under the "survival of the fittest" idea, the present situation as to excess capacity would be corrected by the bankruptcies of the financially weak and the inefficient units until supply and demand approached each other on the basis of conditions existing

at the moment of approach. In industries in which we are certain that the present excess capacity will be permanent, it would be most unwise to interfere with this process. But when it is reasonably certain that the excess capacity will again be needed in the near future, it appears sounder economically and requires less toil from man in the aggregate to try to save the units we now have rather than to destroy some of them and later on find it necessary to replace them. Moreover, destroying units and concentrating production in other units frequently is a great hardship to labor, which may find it necessary to move its residence to the areas containing the surviving units in order that employment may be found.

Another objection to the bankruptcy method is the length of time required to eliminate the weakest units when all are fairly strong, and the enervating effect on the survivors of the internecine struggle. This factor is more important now than formerly because of the tremendous investments in plant and equipment that are necessary for modern industrial operations. Cash expenditures for these assets have been made in the past and—thanks to the ease with which stock sold during the boom—have been largely paid. A prudent management knows that it must provide for the deterioration in and replacement of its equipment by providing a depreciation fund out of its sales prices. On the other hand, a management which is fighting for its existence knows that there is little salvage value in an abandoned plant, and rightly decides that it is better to sell without providing for depreciation than not to sell at all, since depreciation does not represent a current out-of-pocket cost. If the weaker units set selling prices on this basis, the stronger ones are greatly handicapped in maintaining their business and prices on a basis which will care for depreciation.

If this question were to be approached on a sound economic basis, it would be necessary for someone to decide which industries should be permitted to have price protection to maintain the status quo of the present units, because their full capacity will soon be needed, and which industries should be required to work out their destiny by jungle law. The important phrase in the preceding sentence is "it would be necessary for someone to decide" and the practical problem is to find the "someone" who could and would decide equitably in all cases. This "someone" who sits as the judge would need to have an accuracy of vision



and a disinterestedness which it is difficult to associate with ordinary mortals.

However this question of over-capacity is finally settled, there is no doubt that those organizations which have adequate cost data will be in the most favorable position to find their proper place in their own industry. So far as I have been able to learn, there was not much real progress under N. R. A. in assisting business units to determine their costs better than they did before, although there was much talk on the subject. And that is natural, for the development of this information must be expected to require a considerable period of time. I would estimate that if every possible effort were made, it would require from two to five years before really comparable cost data could be obtained in an important industry producing diversified products. The installation and maintenance of a cost system requires the outlay of a considerable amount of money, although executives generally realize that cost data are worth all they cost. But at a time when business was faced with the necessity of decreasing and not increasing current expenses, it was natural that managements should want to know if N. R. A. was apt to be continued on some basis that would permit a use to be made of data that would justify the cost of getting it. Today I am inclined to believe that the anti-trust laws will be so modified as to permit the intelligent coöperative use of cost data, and if this should be so, there will be plenty of work for all the competent cost accountants in the country for many years to come.

A cost accounting system should never be developed until one has become familiar, in the full detail, with the manufacturing operations and the factory layouts in the organizations involved. In other words, it is not a swivel chair job and a man who can not feel at home in the midst of factory operations should never attempt to design a detailed system of cost finding. One must get into the factory, talk to the foremen and to the workers, observe how their work is done and make each installation fit the particular factory in which it is to be used. That would not be necessary if the various units in an industry all made the same things in the same way, but unfortunately, that is not the case. There is a great overlapping of products, and there is also a very real difference in the detailed procedure of manufacturing the same product in different plants. I do not mean to say that the same principles of cost finding can not be applied throughout an industry, or that the final reports prepared can not be in the same

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form; but prescribing basic principles and the form of reports will not mean much in the way of really comparable data unless the basic principles are applied to a particular situation in such a manner as to reflect fully the manufacturing peculiarities of that organization.