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Uniform Cost Accounting Methods of Trade Associations: the Legal Aspects *

BY BENJAMIN S. KIRSH

An impressive literature evidences a virtually universal recognition of the substantial advantages resulting from the application to business activities of sound principles of cost determination. Numerous contributions of accountants, industrial engineers, economists and management executives have sufficiently demonstrated the constructive value of cost-accounting plans. The essential features of such plans are to afford opportunities for educational guidance, through an interchange of practical experience. By means of comparison and analysis of relevant data and by correction of errors the actual production and distribution costs of a company can be determined by the individual members. The increasing acceptance of these instrumentalities in the practical administration of business affairs is ample testimony of the greater degree of efficiency and economy in production, and intelligence in marketing, which have resulted from their use.

There is concurrence in the view that in an era of great complexity in manufacturing and distribution processes, and of narrowing profit margins arising from the stress of the new competitive conditions, business executives have found it necessary to rely upon facts and scientific methods instead of upon rules of thumb or guesswork.

It is to be noted that the application of such quantitative measurements, as is exemplified in cost-accounting methods, is but one phase of a process taking place at the same time in such allied matters as statistics and credit. In the various business operations, the discovery and elimination of wasteful, inefficient,

*The author acknowledges indebtedness to his associate, Harold Roland Shapiro, of the New York Bar, for valuable assistance in the preparation of this article.

unintelligent and unsound practices have become desirable and legitimate objectives of collective, constructive effort.

The law, as well as economic and business thought, has already recognized the evils of overproduction, wide price fluctuations and such unsound practices as the marketing of products at a price which bears no rational relation to the total cost. The recorded annals of industry will reveal the great number of instances in which an ignorance of costs on the part of one member or a small group within an industry has tended to lead a whole industry to sell without an adequate margin of profit or at no profit at all.

In principle, those social advantages which accrue from the application of standardization to machinery and production operations, can be similarly extended to cost-accounting methods. Thus, by exact analysis, careful estimate and specific apportionment of the precise elements of cost, a complete view of the real cost of doing business can be had. In this manner variation in costs and actual conditions of more efficient operating units will be cogently disclosed and the component items of cost will be ascertained. It is only by discovering the cost of each commodity, of each separate process employed in production or distribution, of each separate part which comprises the finished product, that there can be averted what was picturesquely termed by a pioneer in cost education, "shooting arrows in the dark."

Uniform cost-accounting methods, as a trade-association activity, are the logical extension, on a coöperative scale, to an industrial group, of the scientific and efficient technique of individual cost accounting. Such a programme finds a distinguished series of champions. The department of commerce, the federal trade commission, particularly in the pioneer work of Commissioners Edward N. Hurley and Nelson B. Gaskill, the Chamber of Commerce of the United States, and the department of justice, have lent the weight of their authority to the movement.

To this list was added, in 1925, the judgment of the supreme court of the United States, in the *Maple Flooring case* (*Maple Flooring Manufacturers' Association v. United States*, 268 U. S., 563, 585.). "The cost of production," stated the court in that case, "is a legitimate subject of enquiry and knowledge in any industry." It is further significant that there is no opinion of the courts or of the federal trade commission which condemns uniform cost accounting, as defined in this paper, as being in conflict with the anti-trust laws. Such outstanding advocates need no

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additional support. We can therefore refer to the general advantages of uniform cost accounting appearing in a comprehensive collation by the Chamber of Commerce of the United States and pass on to the legal considerations:

Uniform cost accounting

- (a) Provides "one best way" to figure costs, thereby eliminating expensive experimentation within industry.
- (b) Results in a better informed competition.
- (c) Enables industry instantly to place facts before regulatory bodies.
- (d) Inspires confidence in public, that selling price is the lowest consistent with a full knowledge of cost.
- (e) Tends to convince manufacturers of desirability of adopting the plan by showing its successful use by competitors.
- (f) Reveals lines of individual products marketed heretofore on unprofitable bases.
- (g) Provides the valuable features of cost accounting generally, among which are:
 - 1. Shows danger line below which goods sold can not bring profit, thus insuring profits.
 - 2. Guide to value, efficiency, and waste of workers, machines, methods, operations, and entire plants.
 - 3. Reliable guide for estimating cost of prospective business.
 - 4. Furnishes current reports for comparing major cost items with predetermined standards, thereby measuring and increasing operating efficiency.
 - 5. Establishes standard manual of accounting practice, so that a new cost clerk, bookkeeper or accountant will find a fully developed system in operation.

The following is a summary of advantages of uniform cost accounting from Jones' *Trade Association Activities and the Law*:

Sound basis for determination of price; locates and eliminates waste; aids in improvement of quality; aids in stimulating production; aids in bettering credit standing; attracts trade; aids in making tax returns; cost comparisons increase efficiency; cost data of value in relation to governments; stabilization of prices.

A precise definition of uniform cost-accounting methods is essential, for "uniform" is a term which may connote concerted action of a proscribed character and thus inspire probing by the legal mind for possible violations of the anti-trust laws. It is therefore absolutely necessary to define the phrase "uniform cost-accounting methods" in its precise limits, so that an ambiguous phrase will not give rise to serious questions of legal validity.

As stated by the Chamber of Commerce of the United States in one of a series of valuable pamphlets on uniform cost accounting in trade associations:

“Uniform cost accounting comprises a set of principles and in some cases of accounting methods which when incorporated in the accounting systems of the individual members in an industry will result in the obtaining of cost figures by the individual members of the industry which will be on a comparable basis.”

Uniformity in the sense employed, therefore, has reference solely to the standardization, through recognized and proper principles, of the *methods* of cost accounting, and not to predetermined or fixed *elements of cost*. The distinction must be drawn between uniform fundamental theory in cost accounting on the one hand and uniform costs or items of cost on the other. In essence, the uniform cost-accounting plan is an educational service for the guidance of the individual member of an industry in determining his own individual costs and profit margins. It is the gauge of the single member for ascertaining his individual costs and comparing them with the costs of others engaged in the same industry. At all times, however, each member of the association should be free to determine and fix his own costs, in any of the segregated elements, his own margin and his own sales price.

The essential thought is uniformity in principles and similarity in methods. This does not imply iron-clad rules necessitating similarity in every detail for the entire production and distribution process. The employment of uniform methods deals with such general principles as the inclusion of the same items of cost; the adoption of substantially similar classifications of accounts and forms of financial statements; the adoption of a common meaning of overhead or burden and similar classification and distribution of their component elements, and the use of the same principles for classifying the business into proper departments.

As a practical matter, a general survey can not deal with the plans, details or refinements of the particular methods employed in a specific industry. The accounting plan may be condensed or amplified to satisfy special requirements. Individual accounting problems are peculiar and special and thus must be considered in relation to problems of production and distribution incident to a particular industry. The uniformity of cost accounting refers to the practice of an entire industry in contrast to the methods of cost ascertainment employed by any individual member of the industry.

There is great variety in the requirements of various industries, which necessitates an accounting system adaptable to operating conditions in the industry under consideration. First, the accounting plan to be applied may be either of the two general systems of cost accounting, the process-cost, or the specific order or job-cost system. Again, while in one industry the cost of material may require special principles and methods to allocate and distribute elements of cost, in another overhead expenses are the most important factors. Likewise, in some industries, the accounting problems may deal with costs of a large number and great variety of small component parts, while in others there may be only a few staple products. Thus, uniformity of methods of cost accounting must be restricted to accounting systems based upon a common adoption and interpretation of accounting principles, which allocate the various elements of cost into appropriate subdivisions of material, labor and overhead costs.

In the great bibliography to which reference has been made, relatively sporadic and scattered writings consider and examine the legality of uniform cost-accounting practice. However, it can not be doubted that the lawfulness of specific practices is one of the vital considerations in the adoption and practical application of any accounting plan.

From the point of view of the policy of the law in anti-trust matters, the subject matter of uniform cost accounting tends always to bear a more or less distinct relation to uniformity among competitive units in sales policies and practices. From this point of view, there is always present the possibility of an approach to the area where the policy of the anti-trust laws limits and even forbids certain features of accounting practice which bear a direct and substantial relation to concerted price and production activity by the industrial group.

The aspect of uniform cost-accounting technique as part of an unlawful agreement or course of conduct prohibited by the anti-trust laws is, in the ultimate analysis, the most vital factor to be considered. By a series of recent decisions of the supreme court, it has now been authoritatively settled that agreements, or a course of conduct, among competitive business units, evidencing the unlawful purpose of controlling prices or limiting production are violative of the federal anti-trust laws.

The business and economic factors and the judicial decisions dealing with trade-association statistics have been reviewed by the

writer in a recent article entitled, *Trade Association Statistics—the Legal Aspects*.^{*} Statistical and cost-accounting activities intersect at numerous points, and it would be well to consider them together. It is to be observed that, as regards the various fields of trade-association activity, a more favorable attitude, permitting a more extensive area of operation, has been announced by the supreme court in its latest decisions dealing with these matters.

Under the law, as now interpreted by the supreme court, the fact that a uniform cost-accounting plan contains possibilities of abuse, or that price agreements among competitors within an industry may be rendered easier because of the standardization of practices, can not be relied upon as an absolute argument that such practices are in and of themselves illegal. Certain features, described in greater detail hereafter, should be omitted. An unlawful agreement, or a course of conduct evidencing such unlawful activity, must be proved before any violation of law can be said to have occurred.

In considering the legal aspects of uniform cost-accounting methods, it is to be borne in mind that the underlying purpose and the necessary result of the plan will, in general, afford the key to the determination of lawfulness. It is only where the accounting plan is perverted and is being employed as a cloak or an instrument to effect a prohibited agreement, either express or implied by a continuous course of conduct, that the plan must be deemed illegal in its entirety. Therefore, where its main purpose is educational and where it deals solely with information setting forth a guide to each member for the intelligent and scientific distribution or allocation of cost items, there can be no legal objection.

The individual must deal with his own actual costs and not with an arbitrary, artificial or supposititious uniform cost base. He must not, therefore, under pressure from members of the industry, follow theoretical or ideal standard production or distribution costs, such as, for example, specific rates of depreciation or obsolescence, or arbitrary estimates or rates for insurance, rent, light, heat or power, or for repairs, which bear no direct relation to actual charges. Similarly, to adopt a cost, at a general supposed market value, of raw materials purchased at different prices at different seasons, especially when the market price has risen,

^{*}*American Bar Association Journal*, March, 1928.

evidences an illegal activity of fixing an element of material cost. The difference between uniform cost-accounting principles and uniform costs or elements of cost was forcefully stated in correspondence between Harry M. Daugherty, then attorney general, and Herbert Hoover, secretary of commerce, where the attorney general stated:

"With reference to the first paragraph, there is no apparent objection to a standard system of cost accounting, but I think associations should be warned to guard against uniform cost as to any item of expense. For illustration, a strong effort has been made by some lumber associations to take as a basis for estimating costs of production a uniform charge for stumpage. Of course the cost of the timber in the tree to the different manufacturers who own their timber in the woods greatly varies; and as to each it should be charged at its actual cost. It is as clearly a violation of the law to agree upon the cost of an item that constitutes a substantial part of the total cost price when its cost actually varies, as to agree upon the sales price, because the sales price is substantially affected by such agreement. It has been ascertained that the members of one association go so far as to fix a uniform cost price, leaving to each member to determine what per cent. profit he will add, thus eliminating entirely competition in so far as affected by the cost of production."

In a strict sense, the Maple Flooring case is the only decision in which the supreme court of the United States has reviewed the legal limits of uniform cost-accounting technique. It must not be supposed, on this account, that the entire law concerning the forbidden or permissible practice can be found within the limits of this opinion, nor must it be presumed that the accounting plan involved can be considered a model from the accounting point of view. Cases dealing with the anti-trust laws can not be regarded in isolation. They must be viewed compositely. Likewise, there are other persuasive expressions to be found in diverse sources to which one may look for guidance. But it must, nevertheless, be remembered that it is only in the adjudications of the supreme court that the ultimate authoritative decisions of the legal aspects of uniform cost accounting can be found.

The decision of the supreme court in the Maple Flooring case is latest in time, as well as being ultimate in authority. It is to be remembered that the opinion in this case deals also with problems other than uniform cost-accounting methods. Closely related, and indeed, as part and parcel of the practices there considered, were the statistical activities of the Maple Flooring Manufacturers' Association. These must be considered in so far as they have a bearing on the uniform cost-accounting problem involved. For while there may seem to be certain differences in emphasis or

approach between the statistical activities of trade associations and the uniform cost-accounting methods, in many respects the fields intersect and analogies can be drawn from both. As the Maple Flooring decision is the only decision of the court of last resort which directly decides the legal issues here discussed, a careful analysis of the holding of the court is necessary.

The Maple Flooring Association collected, computed and distributed among the members of the association the average cost of their product and of all dimensions and grades of flooring. The three principal elements which entered into the computation of the costs of the finished product were the cost of raw material, manufacturing cost and percentage of waste in converting rough lumber into flooring. The information upon the cost of rough lumber was obtained by the secretary from the reports of actual sales of lumber by members in the open market. Between five and ten ascertained sales were taken as the standard, and these supplied the average cost of raw material. Manufacturing costs were ascertained by securing from the reports of the members, in response to the association's questionnaires, information as to labor costs, cost of warehousing, insurance and taxes, interest at six per cent. on the value of the plant, selling expense, including commissions, cost of advertising and depreciation of plant. From the total reached in this manner, there was deducted the net profit from wood and other by-products. The net total cost thus determined was then averaged.

The percentage of actual waste in converting the rough lumber into flooring of different sizes was determined on the basis of a given amount of rough lumber, by test runs made under the direction of the secretary of the association by selected members of the association.

By combining the three elements of cost thus found, namely, the cost of raw materials, manufacturing cost and the percentage of waste in converting the rough lumber into flooring, the total cost per thousand feet of the aggregate of the different types and grades of flooring produced from a given amount of rough lumber was estimated. To this cost, there previously had been added an estimated five per cent. for contingencies; but this practice was discontinued by the association about two years prior to the decision of the supreme court.

In order to determine the cost of a given type or grade of flooring, it was necessary to distribute the total cost of the

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aggregate of the different types and grades of finished flooring produced from a given amount of rough lumber among the several types and grades thus produced. The distribution was made by the association and the estimated costs thus determined were tabulated and distributed among the members.

It is important to note, as the court points out, that in the bill of complaint against the association, there was no substantial claim made that the estimates of cost by the association were not prepared with all practicable accuracy, or that they were in any respect not what they purported to be, that is, an estimate of the actual cost of the various grades of finished flooring fairly ascertained from the actual experience of the members of the association. The government contended that the distribution of the costs among the several types and grades of finished flooring produced from a given amount of rough lumber was necessarily arbitrary and that it might be or become a cover for price fixing. But the mere fact that price fixing might become easier, upon the facts there considered, was not deemed sufficient by the court to condemn the plan.

As the court pointed out, neither the government nor the defendants attempted to prove upon what principle of cost finding the distribution of cost was made; nor was there any data from which an inference could be drawn as to whether or not it conformed to explicit principles of cost accounting applied to the manufacture of a diversified product from a single type of raw material.

The opinion further shows that on July 1, 1916, the association had adopted in its articles a minimum price plan which it was claimed had been in effect until about January 1, 1921. Under this plan, there was to be established a minimum price of maple, beech and birch flooring by members of the association. These prices were to consist of the average cost and expense of manufacturing and selling the product, plus an average profit of ten per cent. Drastic penalties were provided under the plan, for the sale of flooring at less than the minimum price so established. It was also charged that on January 1, 1921, the defendants, by agreement, had established a minimum price basis for the sale of flooring for the ensuing year. Under this plan, the average net profit had been reduced from ten to five per cent., and penalties for non-compliance with the minimum price scale had been abolished. However, it was conceded that each of the plans just enumerated was abandoned and that both by resolution and in

actual practice, the association had confined itself to the activities previously described.

Furthermore, Justice Stone, in his opinion, stated that the practice of identifying the number of the mill making the report had been discontinued about two years prior to the decision in the supreme court.

In addition, it is important to note that the reports were not secret, but on the contrary were made available to the public:

“The statistics covered by the defendant association are given wide publicity. They are published in trade journals that are read by from 90 to 95 per cent. of the persons who purchase the products of association members. They are sent to the department of commerce, which publishes a monthly survey of current business. They are forwarded to the federal reserve and other banks and are available to any one, at any time, desiring to use them.”

In considering the effect of the decision in the Maple Flooring case upon uniform cost-accounting methods, it is to be observed that the court removed the doubt which seemed to exist prior to the decision with respect to the legality of the dissemination of average costs, and also established the right to discuss cost information provided that no agreement was reached or attempted or any concerted action pursued dealing with prices, production or other unlawful activities. The dissemination of average costs of several varieties of products, as the statement of facts reviewed above has indicated, was one of the essential features of the cost-accounting plan in the Maple Flooring Association. But it is most important to observe that the court's permission to circulate average costs was carefully coupled with the express condition that it be not made the arbitrary basis for determining cost, margin or sales price. The individual must exercise his own initiative, discretion and judgment in these matters, in contrast to the dictates of the membership of the association.

Of particular force to uniform cost-accounting practices is the ruling in the Maple Flooring case that individual concerns must be “left free to base individual initiative on full information of the essential elements of their business,” and that members of trade associations make use of the cost data only “in the management and control of their individual businesses.”

It must also be noted that the court said:

“Both by the articles of the association and in actual practice, members have been left free to sell their product at any price they choose and to conduct their business as they please.”

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The court recognized, furthermore, that average costs, coupled with an agreed margin of profit, could be made the basis of an unlawful price agreement.

As the court stated:

“It can not, we think, be questioned that data as to the average cost of flooring circulated among the members of the association, when combined with a calculated freight rate which is either exactly or approximately the freight rate from the point of shipment, plus an arbitrary percentage of profit, could be made the basis of fixing prices or for an agreement for price maintenance which, if found to exist, would, under the decisions of this court, constitute a violation of the Sherman act. But, as we have already said, the record is barren of evidence that the published list of costs and the freight rate book have been so used by the present association.”

Finally, the averages were made with practicable accuracy and were bona fide, representing actual transactions of members of the association.

Prior to the decision of the supreme court in the Maple Flooring case, the federal trade commission had entered a cease and desist order on August 17, 1923, which dealt with the alleged violations of the anti-trust laws in the Tyothetæ case. The order of the federal trade commission was clarified by subsequent correspondence of the commission dated December 21, 1923. The entire proceeding was discontinued by stipulation. This case has been ably discussed by Lawrence in his excellent book on *Cost Accounting*.

The conclusion is there advanced, upon consideration of the cease and desist order and the subsequent letter of the federal trade commission, that the general scope and purpose of the order was directed solely against the alleged practice of using cost figures in order to effect the adoption of uniform selling prices. The order therefore contained a prohibition against the publication of the data for price-fixing purposes, which was alleged to be evidenced by the publication of predetermined, standard cost figures coupled with a recommendation of a fixed rate of profit of twenty five per cent. In their defense, the United Tyothetæ set forth that they were not guilty of engaging in some of the practices complained of, and had discontinued others deemed objectionable.

In the absence of a judicial review of the federal trade commission proceeding, and in view of the discontinuance of the case and the subsequent decision of the supreme court in the Maple Flooring case, the value of this proceeding is necessarily lessened. Various other federal trade commission statements indicate that

where the cost accounting plan is perverted to induce group action with respect to the selling price rather than to encourage individual education in cost finding, the activities are no longer permissible.

While the trade association may afford the facilities for education in cost finding, the individual must never be compelled by pressure from the association, or its officers, to conform to group activity.

From a composite, comprehensive review of the judicial decisions, recorded proceedings and expressions of the federal trade commission, the views of the department of justice and other persuasive statements on the subject matter of the lawfulness of uniform cost-accounting practice, some rules for guidance may be indicated. It must be assumed, of course, that the accounting plan is being pursued for legitimate, constructive purposes and is not being employed as a cloak or instrumentality for unlawful agreements or concerted action on the part of the membership of an industry with a view to an illegal control of production or price policies.

A finding that such an unlawful agreement or course of conduct exists must lead to a condemnation of the accounting plan in its entirety. It must likewise be borne in mind that the suggestions which follow must not be taken as an unerring enumeration of the practices allowed or forbidden by the law. They are significant features, the presence or absence of which has influenced the views of the courts and administrative officers of the government in enforcing the provisions of the anti-trust laws. All the facts of any case in their direct relation to unlawful price or production policies on the part of a group within the industry constitute, in the last analysis, the fundamental factor in passing a final judgment. But as the finding of certain conditions would, in practice, tend to indicate a plan violative of law, it may be valuable to point out the significant features which have been noted by the courts, so that proper precautions can be taken and the cause for dissatisfaction removed:

1. The cost data must be as accurate as practicable. The figures must be based on actual and not on fictitious or arbitrary information. They must be fairly ascertained from the actual experience of the members reporting to the secretary, and must be accurately reproduced in the reports of the secretary to the membership. The data should not, therefore, be inflated or

colored by the inclusion of items not actually present in the elements of cost of the reporting members.

2. There must be no recommendation, advice, comment or criticism with respect to the amount of any item of cost, rate of profit or selling price to be set by the individual member. The items of cost are not to be made the basis for an agreement by the group within the industry as to the selling price by the individual member. The decision of the supreme court in the Maple Flooring case apparently permits the discussion of cost data as well as comparative analysis by the individual member. But no agreement or attempt to agree on cost, or any specific item thereof, margin, sales price, production policy or any other unlawful activity is permitted.

3. The cost information must be essentially educational and informative in character. While the group in the industry may be educated in proper methods of cost accounting, it is of the utmost importance to bear in mind that the use of the cost-accounting data is a matter of individual choice. The member must exercise his own initiative, discretion and judgment in determining and fixing his own cost, margin and selling price. He must at all times be free to follow his own will in contrast to pressure from without by the association or any of its officers.

4. The cost information should be published or made available to those who are not within the ranks of the association or to neutral publications, so that the appearance of secrecy and the possibility of distortion of the information for unlawful purposes by the members of the association may be, in a large measure, lessened.

5. The cost data must be disseminated in such a manner that the information contributed by individual concerns is not identified by name and thus made known to competitors. Anonymous numbered reports by individual concerns, which are not known to the membership of the association, can serve the same purpose as identified reports. They perform substantially as well the service of disclosing the efficiency of business units in the industry. The general policy of the law, similar to the policy expressed in consideration of the general statistical activity of the trade association, is to forbid the identification of each report which would, if allowed, afford the opportunity to lead to the detection of those who did not conform to a preconceived, concerted arrangement to violate the anti-trust laws. It may be

that identification of cost data is not so intimately related to the ultimate selling price, but to refrain from such identification is a safeguard which it would be wise to follow, as the law stands today.

6. There should be no penal provision compelling group action as distinguished from free and uncontrolled individual discretion with respect to cost, margin or selling price. A member should not be subjected to the duress of fines or expulsion for exercising his individual judgment on these matters.

7. Drastic supervision, which is employed to spy upon the activities of a member to discover whether or not he is conforming with the group plan, should be avoided.

Uniform cost-accounting methods will thus be judged with emphasis upon their demonstrated value rather than by the possibility that they have transgressed the technical rules of a forbidding law. Coöperative efforts on the part of trade associations seeking a more efficient, improved, and more serviceable technique will be judged by the law, when pursued within proper limits, with a view to enlarging the permissible area of operation. This seems a fair prophecy, now that the principle of uniform cost accounting has been accepted by the courts, as a sound legal, as well as economic, function.