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Robert E. Belt

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## Importance of True Cost\*

BY ROBERT E. BELT, C. P. A.†

The subject of costs many not be a very entertaining one, but it is one which should be of great interest to business men because it relates to information which is essential to the successful conduct of a business. This is a subject that is at present receiving careful attention on the part of many trade associations and a number of them have achieved marked success in bettering the accounting methods of their members and thereby improving and strengthening their industries in general.

Formerly little attention was paid by manufacturers and by business men to the question of costs. The necessity for a knowledge of costs and its analysis was not so great as the margins of profit were larger. But today margins of profit in most lines are much narrower than formerly and the necessity for the most efficient management and the closest analysis is felt as never before.

It is necessary today for a manufacturer's success that he know on what articles he is making a profit and on what he is incurring a loss. Prominent vehicle manufacturers recently made the statement to the federal trade commission that they were forced, for their own protection, to install an efficient cost system. This cost system showed them, they said, that they had been in the past laboring under wrong impressions. They were surprised to find that where they thought they were making money they were not making it, and that certain lines they were not pushing were affording a far greater percentage of profit than lines they were actively pushing.

A similar instance which came to our attention was the misfortune of a manufacturer of stoves. He had been making two styles, both on a fairly large scale, and on both he considered he was making a profit, as his balance at the end of the year was on the right side of the ledger and was fairly satisfactory in amount. But for some reason, not clear to him, the one style

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†Of the Federal Trade Commission.

### *Importance of True Cost*

was selling much better than the other, so he gave orders to his salesmen to drop the one to push the good seller. Everything went along well, but at the end of the year things did not come out right. He was at a loss to understand the situation; so he called in an accountant and much to the manufacturer's astonishment the accountant convinced him that the stove that he had been pushing had been sold for years at a loss. The only profit he had ever made was on the stove he had slighted for the reason that it was not selling as readily as the one he had been disposing of at less than cost.

Unfortunately the value and importance of proper cost accounts are often underestimated. So long as the details of a business can be carried in mind, cost records are not so essential, but when this cannot be done it becomes absolutely necessary for the safe conduct of business that cost records be kept. They serve three broad purposes: first, they show the cost of each job or product; second, they permit the elimination of unprofitable business; and, third, they establish a correct basis upon which to make future prices. Arbitrarily making a price may result not only in a direct loss but an indirect loss by reason of the demoralizing influence in establishing a false price for future business. A manufacturer owes it to his stockholders, his employees, his customers and his competitors to determine accurately his cost of production. To sell blindly a product of which the complete cost is not known almost invariably produces bad results, not only to the company but to the industry as a whole. Your most dangerous competitor is the man who does not know what his goods cost him.

Another marked advantage of properly kept costs is their value as an index of operating efficiency. With properly prepared cost figures the relative efficiency of the various departments of plants may be watched and compared. The current results obtained in each department may be checked against those obtained in the past, thereby showing increases in efficiency, or the reverse, and the results of improvements in practice. A constant study of properly prepared cost figures will help to bring to light poor and inefficient management and will enable standards to be set for the less efficient departments, based on what actually has been done in departments that are being properly and efficiently ad-

ministered. In other words, a complete and properly kept cost accounting system will be found to exercise the important and productive function of helping to lower costs and holding them at the lowest practicable level.

In my opinion the day will come when the success of a manufacturer will depend upon the information a complete and accurate system gives him. It will be as essential as good workmen and a good organization.

This lack of knowledge of the cost of doing business which is so essential to success is a cause of unfair competition, demoralization and bankruptcy. The fact that our business failures of last year entailed a direct loss to creditors of over \$200,000,000 gives some idea of a part of the economic loss which is placed upon the shoulders of the public.

For this reason every chance should be given a weak and tottering concern to get on its feet if it is doing a legitimate business, as the public suffers every time a business goes to the wall and, conversely, the public is benefited every time a tottering business is saved, if it is a worthy one.

I know I am safe in saying that with better accounting many of our bad business practices would be brought to light and promptly curbed. When accurate results are known to proprietors and to creditors, conditions never become so bad and the losses never so great, as good accounting gives trustworthy information and timely warning.

Undoubtedly ruinous prices are due more to the fact that many manufacturers do not know what their actual costs are than to a desire on their part to sell at prices which do not yield a fair return on the money invested. At times most manufacturers, as a matter of expediency, are obliged to take orders which return little if any profit; but in the great majority of cases I believe that unprofitable prices are made by manufacturers as a result of their not knowing their total and complete costs of production and distribution.

The trouble is that too many people in figuring profit fail to take into account all the expense incurred in conducting their business. There's where the trouble comes in. There is no net profit until everything in the way of expense and service is taken care of, including depreciation, taxes, insurance in all its

## *Importance of True Cost*

forms, losses from bad debts, price discounts and expense in collecting outstanding receivables. The omission of such items as these is the reason that the final profit and loss account at the end of the year is so often disappointing and so difficult to reconcile with the profit percentage that was added to the supposed cost of the goods.

There are in the United States 250,000 corporations exclusive of banking, railroad and public utility corporations. Of this number, over 100,000, or 40%, do not earn a penny for their stockholders. This shows clearly that there is an unduly large proportion of unsuccessful business in the country.

What is the remedy for this condition? The remedy lies in a large measure in cooperative effort to increase efficiency and to eliminate unintelligent competition.

It is the belief of the federal trade commission that if merchants and manufacturers would agree on some standard practical system of accounting, it would go a long way toward eliminating the unintelligent and destructive competition that is so manifest in many of our industries of today.

It is of great importance to the manufacturers of an industry that they agree on the elements or fundamentals of a cost practice, especially to make sure that all the elements of cost are included in their calculations. This is of vital importance. Make sure that you have included in your cost an adequate provision for depreciation and every expense of every description incurred during the year. The test of the accuracy of a cost system is that it dovetails in and coördinates with the financial books of account. The cost then, in the aggregate at least, must be correct.

Production costs, determined by a uniform practice, it has been demonstrated, improve trade conditions to a remarkable degree.

Excellent results are being obtained by trade associations by appointing men to devote their entire time to visiting the concerns that are engaged in their industry, getting acquainted, preaching the gospel of good accounting practice, reconciling differences and standardizing methods. When the person engaged for this work has the subject at heart, is congenial and persuasive and well grounded in the principles of cost accounting, the results in improving the general welfare of the industry are surprising.

There should be no selfish motives back of such service. There should be the same willingness and free spirit to help and to aid and bring in line the non-member of an organization as is manifested toward the member. The non-member is usually the trouble maker. In the interests of the industry, he should be guided by the experience of others. The fallacies and disastrous results of bad business practice should be pointed out to him.

Business men are looking upon activities for the general welfare of their industry in a new light. They are being governed by the single purpose to promote the best interests of the community and of the industry in which they are engaged. They are putting aside sectional differences and there is the broadest and most generous cooperation for the general good. As an example—in the paint industry, one of our largest and most successful establishments has issued a standing invitation to its competitors to inspect its cost records, to adopt its efficiency methods and to profit by its long period of business experience.

The American manufacturer or merchant, generally speaking, is especially in need of such assistance on account of his inexperience to carry on the business in which he engages. We are in this respect at a marked disadvantage as compared with our European competitors. In Europe the business man is brought up in the business that he conducts. He knows his business in all its details, and consequently is thoroughly fitted for his vocation. In America there is a tendency to experiment. The farmer of yesterday becomes the business man of today. The lawyer, the doctor or the day laborer will enter upon a business career in which he has had little or no training. He will depend on the jobber for the selection of his merchandise and on an untrained employee for the care of it. In his effort to attract customers he will mark his goods below the prices of the business man of experience. He is trying to give service for which no adequate provision is made in the margin between cost and selling price. As a consequence there is general demoralization, for, not only is he wasting his own capital, but, what is worse, he is creating a condition with which the man of experience finds it difficult to contend.

The federal trade commission, under the direction of the vice chairman, Edward N. Hurley, is aiding and cooperating with

### *Importance of True Cost*

trade associations and with individual merchants and manufacturers in improving accounting methods and business practice. The preliminary work of the commission has shown that an amazing number of smaller merchants and manufacturers have no adequate system of determining their cost and that they fix the prices of their goods arbitrarily. Various associations appearing before the commission have emphasized the necessity for improvement in this direction before competition can be placed upon a sound economic basis.

The lack of a correct knowledge of one's business carries with it various undesirable results. In the first place, the manufacturer is unable to conduct his business upon sound business principles. The results are reprehensible practices as disastrous at times as intentionally unfair methods of competition. In the second place, he severely handicaps himself in that he is unable when seeking credit to produce a correct statement of his financial condition which would enable a banker to extend to him the full credit to which he is entitled. He thereby hampers and limits the possible expansion of his business. The commission hopes to aid in a constructive way in the correction of these conditions.

The plan, as worked out, is to cooperate with trade associations and others to encourage improvements in accounting methods and business practices, to endorse standard systems of cost accounting for the different lines of trade and industry and to recommend to merchants and manufacturers the adoption of such systems in the interests of better trade conditions. We have for this work experienced accountants and cost experts and the services, in an advisory capacity, of public accountants of national reputation.

If the appropriations of the commission will permit, it is also contemplated to conduct an educational campaign upon this subject among the small retail merchants and manufacturers, making available to them such data as will enable them more efficiently to conduct their business. In other words, the commission expects to aid the business man in much the same way that the department of agriculture is aiding the farmer. It is felt that this line of activity will be of national significance in its results for the following reasons:

First. Because individual enterprises will be helped, in that prices will be placed upon a solid basis of fact and a foundation will be laid for the securing of credit, which will result in a normal and healthful expansion of industry.

Second. Because the investor will be benefited, in that he will be able to invest his money with greater safety and a larger assurance of profit.

Third. Because the public will be benefited, in that unintelligent competition, which ultimately reacts upon the public welfare, will be largely eliminated and inefficient methods and practices, which are costly to the public, will be at least partly eradicated.

The federal trade commission is also compiling information for the benefit of business men, embracing every industry of the United States, showing annual sales, capital invested and the return thereon, together with other information which will be of value to business. This will give every man who is engaged in business an opportunity to know whether or not the industry in which he is engaged is in a healthy condition. The industries in which conditions are not found to be healthy will receive particular attention for the purpose of ascertaining the underlying causes. Not only will this information be of practical value to those already engaged in business, but the knowledge of the existence of generally unhealthy conditions will prevent others from investing in an enterprise when the odds are against them.

The trade commission believes that with the cooperation of business men it can be of constructive help in assisting to bring about better trade conditions—conditions which will lessen our business death-rate, enable our merchants and manufacturers to compete more intelligently with each other and make them more formidable competitors in the markets of the world.