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Direct Versus Absorption Costing: A Reply

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We are pleased that a reader of *Accounting Business and Financial History* was sufficiently stimulated to supply some further thoughts on the subject of direct versus absorption costing. We are also pleased that the editors of the journal have invited us to reply.

The central issue[1] raised is the contributor's view that: 'If a combatant had been made to spell out his case fully, he would have seen that he was right in certain circumstances but not in others'. Apparently, clear-headed debate could have resolved the issues raised during the 'costing war'. Our response is that much of the debate *was* clear headed; but it did not lead to agreement, it led to conflict.

The contributor reaches his/her[2] conclusion following an economic analysis of the arguments for and against the two systems of costing. Direct costs are seen as simpler and consistent with economists' teaching on marginal analysis. However, for practical reasons, direct costs may be incomplete and, even if complete, may 'lure him into an unfortunately low quotation'. Absorption costing was 'more helpful' in providing a guide to prices that covered overhead. However, absorption costs will always be, to some extent, arbitrary because of the treatment of joint costs. A critic will hold that: 'absorption cost can be defended only on the grounds that it works well in practice; it is sadly at odds with principle'.

The contributor's analysis presumes a debate couched entirely in economic terms; but this misses a key issue in our paper: that the costing 'war' *cannot* be understood by simply examining economically rational arguments. A large number of actors, representing different organizations and institutions, were involved in the direct versus absorption costing debate and, to understand their arguments, it is necessary to analyse their objectives and values.

In some cases this is reasonably straightforward. Accounting standard setters explicitly stated their objective of ensuring consistency in financial reporting and the Inland Revenue seemed to be driven by desire to maximize short-run tax revenue. However, in other cases, the analysis is not so simple. We argue that even those who appear to have a common

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Notes

There are a number of other issues where we diverge from points made by the contributor but which are not central to our argument here. For example, in relation to

the comments concerning the development of absorption costing, it is not clear that the rise of absorption costing in the nineteenth century was driven by the increasing proportion of overhead in total costs. Overhead became (even) more important in the twentieth century but this did not prevent the rise of direct costing. We would also see little evidence to support the assertion that '…absorption costing has become more and more complex'. A key element in the 'relevance lost' debate of the 1980s was the finding, especially in the US, that many manufacturing companies had oversimplified by employing only labour hours or cost as an overhead recovery base and sometimes used a single 'blanket' overhead rate.

At the time of writing the contributor remains anonymous to us.

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