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So much has been written on this subject by many of the ablest accountants in the profession, that it is difficult to advance any new reasons why interest on invested capital should or should not be included in manufacturing costs. Some of the reasons why such interest should not be included therein are as follows:

(1) Interest is an income to the one receiving it and a deduction from the income of the one paying it.

(2) Interest on invested capital bears the same relation to the owners of the business as do dividends to be paid out of the earnings of the business.

(3) Interest on invested capital when made an element of manufacturing costs has the direct effect, to the amount of such interest included in the inventory of goods in process and finished product, of anticipating the credit to profit and loss of earnings which are applicable to the payment of dividends and of inflating the above inventory.

(4) As a charge of such interest and the corresponding credit would be only a book entry, there could be no fixed rate of interest to use.

(5) Manufacturing costs, in order to be of the greatest benefit to those directly interested, should be accurate and based on facts and, therefore, should not have included therein an element of uncertainty and of a variable nature.

(6) As an evidence of the trend of official opinion on this subject, it is noted that in two recent publications issued by departments of the United States government, interest is specifically excluded from manufacturing cost.

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The following arguments are advanced in support of the reasons given above:

(1) If interest is an income to the one receiving it and a deduction from the income of the one paying it, it is obvious that interest on invested capital cannot properly be included in cost of manufacture because of the fact that no cash transaction takes place.

(2) When a business is established for the purpose of producing a certain article or articles, it seems entirely logical from the viewpoint of the owners thereof to look upon that business as something material which is going to work for us and return us a profit on our investment. In order to assure such profit it is essential that the necessary equipment be furnished to it—buildings, machinery, etc.—or else it cannot do that for which it was created. Looking at the question from this standpoint, it does not seem equitable to charge the business with interest on the value of the equipment which is furnished to it, but rather that the profit should result from operations which are not restricted or hampered by charges for the use of the indispensable tools of trade.

(3) It is an unvarying rule in accounting that there must be no anticipation of profits and that the surplus shown on the balance-sheet at the end of a period should include only the amounts which result from the sale and shipment of goods or from other actual transactions. Therefore, any portion of interest on invested capital which may be included in the inventory of unfinished and unshipped goods represents, through its inclusion in surplus, an anticipation of earned profits offset by a corresponding inflation of the inventory, and to that extent the balance-sheet is false and misleading.

It may be mentioned that the inclusion in surplus of anticipated profits requires the payment thereon of federal income, war income and war excess profits taxes which otherwise might not have to be paid until a year later when during the ordinary course of business the goods had been sold and shipped and the profit thereon taken into the accounts in the usual and regular manner. On account of the present heavy war taxes, an increase in the year's income resulting from the inclusion of such anticipated profit could easily cause a very substantial increase in the amount of the taxes for the current year, with the possibility of the succeeding year's business showing a loss or a material decrease in the net income, in which event the excessive taxes paid for the current year would not be offset by a corresponding reduction in the taxes for the succeeding year.

(4) The question of the proper rate of interest to use is perhaps the most forceful argument of all those used against the inclusion of interest on invested capital in manufacturing cost. It is unlikely that there would be any unanimity of opinion on this question and the result would be wide discrepancies in the cost of similar products made by different manufacturers. There would also be the temptation to the owners of a business to increase the rate of interest if the volume of sales were diminishing or the profits decreasing, and we would then have the anomalous situation of the books showing a larger income as the result of a larger inventory of unfinished and unsold goods.

(5) In these days of efficient and economical management it is essential to have accurate and actual costs, as no other will be of value to those responsible for the manufacture of the product, particularly when the information is required for comparative purposes. True costs are obtained from true facts, and true facts result from the correct recording of actual transactions. All charges to cost of manufacture should be based on

(a) a decrease in some other asset—as raw materials or factory supplies; or

(b) an increase in some liability — as accrued payrolls or accounts payable.

But when interest on invested capital is included in cost neither of the above takes place, but a credit must be made to some income account.

(6) In the following publications issued by the United States government, recognition is given to the fact that interest should not be included in manufacturing cost:

Uniform Accounting—A tentative proposal submitted by the federal reserve board, dated April, 1917. One page 13, paragraph 17, it is stated that one of the main points to be kept in view is "that no selling expenses, interest charges or administrative expenses are included in the factory overhead cost." This is emphasized by repetition on page 14, paragraph 27, in which it is stated further that such items "should not be included in the inventory in any shape."

Uniform Contracts and Cost Accounting Definitions and Methods—Recommendations by interdepartmental conference consisting of delegates from the departments of war, navy and commerce, the federal trade commission and the council of national defense, dated July, 1917. On page 7, paragraph 3, of general definition of costs, it is stated that "interest, rent and selling expenses will not be allowed as part of overhead cost, but may be the subject of special compensation when so stipulated in the contract."

The accounting classifications issued by the interstate commerce commission do not provide for the inclusion in operating expenses of interest on capital investment, but on the contrary they specify that all interest payable shall be treated as a division of profits (net revenues), that is, be deducted from gross income.