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Is Interest on Invested Capital a Cost?

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It will be readily admitted by all contenders on the much mooted question, "Is interest on capital an element of cost?" that interest actually paid or incurred for current financing of any business is not a cost of production or of operations but that it must be regarded as a part payment out of net income from operations. In other words, if a concern is not able to provide itself with current working capital in order to operate, it must appeal to external sources for aid and share with them some of its profits. Financing of this kind cannot possibly be conceived as having an effect on operating costs. If one borrows money to pay labor, the interest on the loan does not increase the labor cost of production; if money is borrowed for the purpose of buying material, material costs are not thereby increased or affected (in fact, where the purchase is on a declining market costs might actually be reduced), or, if a loan is made to expand the sales, the cost of that expansion is not affected by the interest item. All these things being true, the net profits from operations are not affected by interest paid or incurred for current operating or working capital and the interest expense is therefore a deduction or a division of net profits from operation—in short, a payment of part of these profits to others for the use of outside capital. This payment is in the nature of a penalty on the borrower for not possessing sufficient working capital properly to conduct his business.

Apparently there is no serious objection to the above interpretation of interest paid on borrowed money. Practically all accountants are agreed upon this point and that agreement is reflected in their form of profit and loss statement, which is generally prepared as follows (in summary):

Sales (net)	$......
Deduct—Cost of sales	......
Gross profit	$......

Deduct—Selling and admin. expenses		
Selling expenses	$....	
Administrative expenses	....	......
Net profits from operation		$......
Deduct—Interest and discount on loans		......
Surplus net profits		$......

(Note that interest is a deduction from or a division of net profits from operations)

Now come the Harvard school and its disciples, bolstered up and encouraged by certain economists, with the theory that capital invested permanently in plant and equipment must be viewed from an entirely different angle to capital invested temporarily as a loan. To be brief, the length of time that capital is "tied up" is the crux of the whole problem and that, if capital is "tied up" in fixed assets, the interest thereon then becomes a cost which must be included in a statement of operations before net profits may be determined.

In the same breath, however, these theorists state that interest on invested capital, which they consider as cost, is also a division of income or an earning, so that the interest earned on the invested capital becomes equally available for dividends with the economists' "pure profit."

We have no quarrel to register with the economists. Economic theory may advantageously divide the earnings of business into rent from land, interest on capital and "pure profits." The business man, however, who invests his money and time in an enterprise does so not with an idea of obtaining a certain amount of rent, a certain sum of interest and a remnant of pure profit—he invests for net income, irrespective of the economists' theoretical components included therein. Risk? Of course, he takes a chance and he certainly wants a fair interest on the money he invests. All these factors he must consider before investing and he chooses to invest in business, even though the risk be great, because of the larger returns. The matter of investment is after all a selective process—some want absolute safety with a small return; others are willing to assume certain risks for larger returns. The mere fact that a man invests money in an industry instead of a government bond does not make interest on the sum total capital invested in an industry a cost of operation or manufacture. Nor is there any sane reason for loading the costs with an anticipated earning merely to insure to an investor the return of a certain rate of interest. The profit on the sale, which is composed of all the theoretical elements provided by the economist, is included in the selling price with all real costs so that the sale will actually produce all the elements in the profit, including, if you will, a fair interest on capital invested; and, moreover, this will occur, if all real costs have been included in price making, without anticipating a part of profits on unsold goods.

If interest on capital invested is a cost, why should not the entire profits of a business enterprise be considered a cost? The investor in a manufacturing plant does not want to earn only interest on his capital—he wants more because of the risk involved. To do him justice, therefore, why not charge as a cost all that he wants to make as a profit? Why charge only a part of the net income as a cost? If an industry can only guarantee him a fair rate of interest on his investment it offers him very little inducement to invest because he can secure as much elsewhere without any risk whatever.

If interest on capital is a cost what rate shall be used? And will the inclusion of interest in costs guarantee the return to the investor or to a group of investors organized in corporate form? If it does not, then what purpose is served by the inclusion? To say that selling price would be affected, if not included, cannot be true because, if articles are sold at a price which cannot yield a reasonable interest on invested capital, then those sales are made at a certain price because the public refuses to pay more for them or competition of others has lowered the price, and no matter what a company's cost statistics may show no larger price can be obtained. The only alternative is to make more productive lines or to cut costs, real costs. If a large manufacturer operates a half dozen plants in different states, shall the same interest rate be charged into costs at all the plants or shall the legal rate in each state govern? Shall the plant located in North Dakota include in its cost accounts a higher rate of interest (because the legal rate is higher) than a plant in Illinois? Or if there are two independent competing plants in these states are the costs of production higher in the one than in the other? Are these questions puerile? Hardly, if one considers that the financier of North Dakota can get anywhere from seven to ten per cent. on good farm mortgages, whereas in Illinois he may have to be satisfied with five or six per cent., in neither case assuming any greater risk than in the other. Or is there perhaps some interest norm which fairly measures the interest return on capital investment which an industry should yield which is beyond any question? And, even despite the greatest possible stretch of the imagination, must not such a yield come out of sales, thus forming a division of net income—the theorists' economic interest?

What object is served by including interest on capital invested as a cost and at the same time crediting the cost as an earning, constructing thereby an anticipated profit, which cannot possibly be earned until all the commodities burdened therewith as a cost have been sold? Thus a concern newly organized might operate a number of months, manufacture a goodly quantity of commodities for stock and, without making a single sale, might still show a handsome profit! This condition is the "reductio ad absurdum" of the whole doctrine and yet, wherever interest is charged into costs, this condition is always recurring because profits appear at all times on unsold goods. The inventories of unsold goods contain a value increment which is income to the investor. Either the economic doctrinaire, who believes that inventories should be valued at cost plus an interest return to the investor is right or the accountant, who believes that inventories should be valued at cost or market whichever is the lower, holds the correct view. The banker and United States government have both adopted the accountant's position and it is certainly a conservative one.

Is it impossible to get satisfactory profits from industrial operations unless interest on invested capital is included as a cost? The investor in industry wants a certain return. Let us suppose that he demands ten per cent. on his capital. If he charges costs with five per cent., thereby including part of his return in advance of sales, he must so adjust his sales price that it will yield him the additional five per cent. when the sale is actually consummated.

What is the difference between such a plan and another whereunder no profits are anticipated and the sales price based on real costs is so adjusted as to yield the requisite ten per cent. and to yield it when it is actually collectible and may be considered as real income? From this angle, the inclusion of interest in costs appears to serve no purpose whatsoever except to distort inventories and earned income and therefore to make periodic adjustments to earnings and inventories necessary in order to resolve the accounts into a status which represents the results from operation in their true light. If interest on capital invested is actually a cost, why do the exponents of that theory admit the need of adjusting the inventories when the same results are obtained by the non-inclusion of interest? Why adjust something that is correct? If the interest-as-cost doctrine falls down when the annual profits are to be stated, is that not in itself a frank admission of its fallacy or does interest represent a cost during the year and not a cost when profits are fixed? If the profits are so adjusted that the interest-as-cost element is subtracted at the end of a fiscal period why go to the extra labor and expense of figuring it currently? Why not exclude it entirely rather than admit that it must be excluded in order to state profits correctly? Why burden the cost accounts, already sufficiently complex, with an element which is admittedly an anticipated earning and cannot rest on its own bottom with reference to inventory (cost) valuations when the real profits are figured?

Capital invested in plant is a method of permanently financing future operations. Capital borrowed from time to time is a method of financing current and partly future operations. Both are of exactly the same nature—the long time financier or speculator demanding small security but good profits, the short time financier asking for an ample security and a fair rate of interest for his loan. If interest on borrowed money is not a cost, by what logic can interest on money furnished for a longer time be admitted as a cost? While capital invested in plant (which is the owner's or stockholder's capital) cannot legally be regarded as a loan it is in essence identical with borrowed funds—in both cases a reward for abstinence is expected and in both cases the principal must not be diminished. In one case it is expected that the principal be returned intact, in the other that it be retained or preserved in undiminished form. Both of these things can be accomplished without considering interest as a cost.

The inclusion of interest as a cost in no way affects the results from operations; it does not insure an income nor is its inclusion necesssary for pricemaking or for profit assurance. In fact, it cannot possibly affect operations except to load them, in accordance with a proportioned charge based upon the relative values of capital assets employed, which are already loaded with "overhead" on the same basis for other charges based upon the same relative values of the operating capital. Depreciation, taxes, insurance, etc., are expenses prorated in cost accounting according to the relative values of equipment and property utilized in production so that distinctions of varying values are fully covered. The inclusion of an interest charge would merely add an extra burden prorated in the same way and would merely increase the final sum of "overhead" chargeable to production; the proportionate relations between costs on different lines or between different departments, processes or production orders would not be affected; the final amounts tabulated by the cost department would merely be increased by the total amount of interest earned—earned before the sale was made!

Is money tied up in materials, in accounts receivable, in goodwill, in labor, in customers' notes and in all other forms of productive assets different from capital invested in fixed assets? If interest on the latter, which is consumed in operations, is a cost of production, why should not interest on the other assets and outlays (to be consumed or used in operations as well) also be charged as a cost? Why discriminate so illogically between capital which is equally employed in production and is consumed or exhausted in practically the same fashion? Raw material disappears as raw material when processed; its value is recoverable through sales. The plant exhausts itself and gives up part of its material utility to every commodity produced. That exhaustion is as much a current benefit to production as the use of raw material and is equally recoverable through sales. The raw material content of production eventually becomes cash—the depreciation or exhaustion of plant comes back in the same way. If the cash were used to repurchase the same quantities of material used up or to restore the plant exhaustion, the condition would be the same as it was initially. The point is that capital invested in plant is a deferred charge to operations and that it finds its way into operations currently in exactly the same way as any other force or factor of production. Why, then, treat one section of capital in one way and the other differently? Why not for the sake of consistency either charge interest on the entire net worth of a concern as a cost of production or include the entire net profits which are to be made? Why be so modest as to assure the investor, who wants profits and large profits, a mere interest pittance which he can earn anywhere without worry, attention or risk?