Correspondence

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"For the Good of the Profession"

Editor, The Journal of Accountancy:

Sir: In connection with your editorial in the last number of The Journal, the enclosed clipping may be of interest.* You see human nature is pretty much the same in other professions than accountancy!

But after all, is it so much professional jealousy as dislike to appear in the role of "Professor Know-it-all" that deters so many from publishing professional data and experiences? I have noticed at conventions and local association meetings that after the discussions get everybody warmed up, there is no lack of interesting statements of experiences and opinions. But every chairman who has conducted one of these discussions knows how hard it is to get them started.

As a case in point I note quite a lively controversy is fairly under way in The Journal on the subject of interest as part of manufacturing or production costs. Doesn't that seem to point the way to induce freer expressions of opinions and experiences? In short, let The Journal assume the role of chairman of a general debate, propound the problems and invite general discussion.

As an example: What is the proper place for depreciation in an income statement?

Yours truly,

W. H. Lawton.

May 11, 1913.

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* Suppression of Technical News

(From The Engineering Record)

Dear Sir: I have read with a great deal of interest the editorial in the Engineering Record of March 15 entitled "Suppression of Technical News." You have expressed my sentiments, and especially in the paragraph reading as follows: "The suppression of so much good engineering information until it becomes too old to be of much interest is due to a very common misapprehension as to what constitutes technical news."

Most engineers have adopted this policy largely, I think, because of what might be termed "professional jealousy"; but it has been my idea for several years that the principle is wrong and that we do one another an injustice by not publishing for the benefit of our fellow engineers such data as would be of service to us.

P. H. Norcross.

Atlanta, Ga.
Correspondence

Interest a Factor of Costs?

Editor, The Journal of Accountancy:

Sir: I have read with much interest the articles published in The Journal on the question proposed in its April issue, i.e., "In a manufacturing business shall interest on investment be considered as a factor of cost; or shall it be treated as a deferred charge against profits?" and believing as I do your statement that "the matter is one of considerable importance" and one which demands "a practical settlement," I venture to accept your invitation for further comment on the arguments so far advanced.

The principal reasons for the inclusion of interest as a cost element are given in your articles as follows:

Professor Cole gives two arguments: first, because the enterprise to be self-supporting must yield sufficient income to give a proper amount of interest on the investment; second, because the inclusion of interest is needed as a guide in determining the comparative costs of production as between processes requiring the use of expensive machinery with heavy investment of capital and processes in which there is a larger use of labor requiring less investment of capital.

A. Hamilton Church makes a distinction between interest on borrowed capital and interest on that part of the invested capital of a manufacturing business which is "represented by land, buildings, plant machinery, stores and work in progress," but states that interest on capital so invested for use in manufacturing should be charged as part of the cost of manufacturing in order to know the comparative economical value of the different processes used in manufacturing, and should be added to the cost of the output.

Edward L. Suffern agrees with the main contention of the advocates of interest as one of the elements of production, stating that so far as the manufacturer who borrows all his capital is concerned, his costs do not terminate nor do his profits begin until this interest is earned and it is certainly part of his cost of doing business.

Mr. Suffern also states that interest should be included in the cost of manufacturing in order to know the relative advantages of special as against regular classes of output.

J. Lee Nicholson gives a further reason for including interest as part of the cost of doing business, in the greater risk of capital invested in manufacturing enterprises as against its investment in stocks, bonds or real estate. Mr. Nicholson states his agreement with the reasons advanced by Professor Cole and A. Hamilton Church.

The first reason given for the inclusion of interest on investment as part of the cost of production by Professor Cole is that the enterprise to be self-supporting must yield sufficient income to give a proper amount of interest on the investment.

I submit that this argument does not apply to the question proposed, as it would make no difference to the income of an enterprise whether
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the interest were treated as a factor of cost or as a deferred charge against profits; the net result or income would be the same.

The second argument by Professor Cole is that in order to know the comparative economical cost of two processes of manufacture the interest on machinery used must be taken into consideration.

The illustration given by Professor Cole is a simple problem in the relative economical value of two processes of manufacture, one using expensive machinery, the other using hand labor, and his argument is that a proper comparison of the cost of these two processes must include the interest on the expensive machinery. Certainly any business man before undertaking to invest new capital or his surplus working capital in expensive machinery, would make a careful calculation before he purchased such machinery to ascertain whether the actual profits derived from its use would pay the cost of procuring such new capital and still show a surplus over the profit derived from the hand process. This is quite a different matter from the theory advanced of charging the interest on the purchase price of such machinery as part of the manufacturing cost of the articles it produces, as it simply is not part of the manufacturing cost of same; but to make this statement does not mean that the manufacturer cannot reimburse himself for the cost of the new capital necessary. He certainly should and actually does, but he should do so by making his selling price include the manufacturing costs, commercial costs, financial costs, and also an adequate profit to compensate him for the risk he assumes in making the investment.

It will be noticed that none of the reasons given for the inclusion of interest as a factor of cost is based on fundamental principles of accountancy. Mr. Church states that "the general principle we must apply in discussing this question is that of utility," and calls the kind of interest he advocates "an assessment for the use of capital values in the actual process of manufacturing." Now if, under the methods of cost accounting which do not include interest as a cost factor, there is no provision made to provide compensation for the use of capital values represented by land, buildings, plant machinery and other needed facilities for manufacturing, in this case Mr. Church would have pointed out an omission which should be corrected. But such is not the case. Modern cost accounting does provide an adequate charge to each article manufactured or job performed for the use of the manufacturing facilities needed by arranging for a proper charge to output for the depreciation caused by the manufacturing process. This assessment for depreciation when properly made provides for the repairs needed and replacement of old buildings, machinery and machines by new buildings, machinery and machines, and places the entire burden of this repair and replacement cost on the articles manufactured and jobs performed in exact ratio to their use of these facilities, so that the entire capital investment in plant is preserved without impairment at its full original asset value, by an "assessment for the use of capital values in the actual process of
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manufacturing”; but this “assessment” is called depreciation by most cost accountants.

In the operation of a manufacturing business the following processes are fundamental:

- The production of some article or substance.
- The selling of its product.
- The shipment of its goods.
- The clerical work necessary to transact its business.
- The administration of its business and financial affairs.

To undertake the work, capital is invested in a manufacturing plant to make its product, and also in a place and facilities for and expenses connected with the sale of its product, i.e., a selling force, a shipping force, office force, and working capital to run the business. So it is assumed that your question—“In a manufacturing business shall interest on investment be considered as a factor of cost?”—does not contemplate the division of capital made by Mr. Church, who ignores all investment of capital necessary to perform commercial functions and makes the interest he advocates apply simply to that part of the capital values used in manufacturing processes and the facilities of manufacture, while it is claimed by those who differ from his view that for the use of these facilities proper depreciation charges make ample provision up to the point where it is not a question: “What has the use of this machine or shop cost us in the production of this output?” but “How much interest are we entitled to charge on the cost of this plant investment to add to the cost of operating its facilities? For instead of investing our money in this business, we might have purchased government bonds at 3%, or other bonds at from 4% to 6%, or possibly some speculative industrial which might have yielded 8%, so we do not know just how much interest we should charge to cost of manufacturing output.”

The question at this point becomes not a question of cost accounting; all the actual costs have been provided for. It is not a question of comparative economy in the use of certain processes; that has been provided for on the basis of actual cost of process plus actual cost of machinery impairment and wear and tear in each process. It is now simply a question, from the point of view that would include interest on investment as a manufacturing cost: How much interest on my money do I consider an adequate return for my investment in this plant? Then in accordance with the personal decision of such a manufacturer all his manufactured goods and goods in process are charged with whatever rate of interest the manufacturer elects to charge for his money, and the interest department of his profit and loss account is credited with this absolutely artificial and fictitious amount, which then appears on his balance sheet as part of the asset value of his manufactured stock.

Now, if it be granted that the manufacturer has a perfect right to make whatever rate of profit he can secure from the sale of his goods, at least let common business honesty prevail at this point; and let him in his calculations of price keep his cost figures intact and accurate, so

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that his manufacturing cost values will in his financial statements reflect
the universal meanings attached to these words by investors who buy
bonds and by bankers who depend upon the honesty of the balance sheet
to furnish an accurate view of the assets and liabilities of those with
whom they transact business.

To do this will not in any way limit the profit any manufacturer
desires to make, for having ascertained the exact cost of his production,
the exact cost of selling and shipping his goods, and cost of his office,
administration and financial requirements, he is in a position to add to
these several factors of cost and commercial expense the factor of
desired profit to his selling price—all without recourse to any devious
or doubtful presentation of asset values. Furthermore, the profits shown
by this process will not include anticipations made before the goods are
sold, but will be actual earned profits based on actual sales.

It might be well to point out the further drift of those advocating
the addition of interest to manufacturing cost. Mr. SUFFERN states that,
in the case of a man who borrows all his capital, as there can be no
profits to him until his interest has been earned, such interest is part of
his cost of doing business. Mr. NICHOLSON states that interest on cap-
it should be charged to proper expense account before ascertaining
the actual profit from manufacturing or trading, and quotes from Mr.
WEBNER's Factory Costs to the effect that rental of buildings for manu-
facturing purposes and interest on investment are similar charges, and
that hence such interest is a manufacturing expense. He also quotes
from STANLEY GERRY'S Multiple Costs, "We may even carry this a stage
further, and also charge to the factory interest on stocks of raw ma-
terial."

It is quite clear that here is the climax of the absurdities involved in
applying the erroneous proposition that interest is a cost charge. Con-
sider the condition of a manufacturing business in which through a
mistake of judgment in the purchasing department, 300,000 pounds of
rubber was purchased, enough for two years' operation, at what was
thought to be a very low price. In the meanwhile the price drops still
lower, and at closing period the cost accountant of the new school takes
this stock of raw material at cost, and then adds to this cost interest for
one year on the investment price of the raw rubber on hand at (?)
per cent, making a nice profit.

It may be urged that he should drop to market price, but he cannot
consistently do this, because he must secure for the firm at least the
interest charges on their capital investment in raw rubber. It is signifi-
cant that the balance sheet, with its message to the manufacturer, to
outside investors and the financial community, is not even once men-
tioned by advocates of the new interest cost theory.

Men do not invest money in manufacturing businesses to get interest
for their money but for the profit they expect to make. Let us keep
the distinction clear between the manufacturing costs of production and
the commercial costs of selling and financing a business, not only for
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the sake of clear analysis, but to secure a sound basis for the fixing of prices to give adequate profit, and for the further reason of meriting the confidence of both manufacturers and bankers in the asset values shown on the balance sheets we prepare, which should not be inflated by fictitious additions to actual cost values.

Yours truly,
Edward C. Gough, C.P.A.

Michigan C. P. A. Law Amended

A bill, which has passed the house of representatives and senate of Michigan and awaits the governor's signature, modifies in some degree the C. P. A. law of that state. It involves the following changes:

Members of the state board shall hold office until their successors are appointed.

The two-year requirement heretofore a part of the rules of the board, requiring two years' continuous practical experience in public accounting immediately preceding the date of application, is now a part of the law.

A bond of $5,000, which was required to be filed under the old law, if allowed to lapse acts as an automatic revocation of certificate, but certificate is renewed on renewal of the bond.

All audit reports signed as C. P. A. must bear the date of the holder's certificate and the date of the expiration of the surety bond, and shall be signed only by actual holders of certificates; and any corporation or partnership signatures will be considered a violation. The signature of the C. P. A. so affixed shall be permitted only to certified public accountants who shall have performed the examination in person, and any literature or reports issued indicating C. P. A. service shall be considered a violation of this act, unless the signature be that of a holder of a certificate issued as provided by law.

The bill if signed will become a law August 15th. Thereupon a new board will be appointed by the governor.

Michigan C. P. A. Board

The governor of Michigan has appointed the members of the state board of accountancy as follows:

Archibald Broomfield, attorney, Big Rapids.

Terms expire January 1, 1914, 1915 and 1916 respectively.

The new board held its first meeting and organized May 3, 1913, and set June 12 and 13 for examinations.