Taylor & Francis Online
Log in | Register
Cart

Financial Analysts Journal ›
Volume 19, 1963 - Issue 6

6 Views | 0 CrossRef citations to date | 0 Altmetric

Research Articles

Viewpoint of Financial Management: Considerations Underlying Cost of Capital

Paul M. Van Arsdell

Pages 69-76 | Published online: 31 Dec 2018
Cite this article https://doi.org/10.2469/faj.v19.n6.69

CFA Institute member access to the Financial Analysts Journal.

Sample our Mathematics & Statistics Journals
>> Sign in here to start your access to the latest two volumes for 14 days

Citations Metrics Reprints & Permissions Read this article

About Cookies On This Site

We and our partners use cookies to enhance your website experience, learn how our site is used, offer personalised features, measure the effectiveness of our services, and tailor content and ads to your interests while you navigate on the web or interact with us across devices. You can choose to accept all of these cookies or only essential cookies. To learn more or manage your preferences, click “Settings”. For further information about the data we collect from you, please see our Privacy Policy

Accept All
Essential Only
Settings

Click to increase image size

Considerations Underlying Cost of Capital

by Paul M. Van Arsdell

COST OF CAPITAL is in the air. The economists, both quantitative and institutionalist, are analyzing the concept; the lawyers have dealt with it even at the level of the Supreme Court of the United States; the accountants now manifest an interest in it; and financial management must comprehend it in discharging the vital planning function in business enterprise.

The planning responsibility is closely interdependent with the analytical, creative, protective, and disclosure functions of management. The very essence of business enterprise is economic in adaptation of productive endeavor to the satisfaction of wants under profit objective; enterprise operates within a framework of law; success or failure in the quest of profit is measured and disclosed in the accounts and accounting statements; the implementation of the enterprise is through capital, in the sense of dollar funds committed to its uses. Accordingly, the managerial viewpoint is properly conditioned by economic, accounting, legal, and financial considerations with substantial reciprocity as well as divergence among the respective associated approaches.

The reciprocity and divergence of approach are logically inherent in an analysis of cost of capital. Both *cost* and *capital* are terms widely employed in the literature of economics, accounting, law, and finance, and it might be difficult to determine which of the two has the greater diversity of meanings in the arrays of their uses. The concepts of the terms differ not only among these four areas of inquiry, but also within each of the respective fields. However, the implications are less of confusion than of challenge to an understanding of the refinements of thought identifiable with the several lines of its development.

THE ECONOMIC APPROACH

Economically, cost is regarded as a matter of human sacrifice, or pain of effort, incurred in the productive process. Although measured pragmatically in dollars, economic cost rests finally upon a psychological foundation. Moreover, economics frames cost in a reference of price, equating cost with utility at a point of marginal equilibrium. It is significant that in the theoretical build-up of economic cost to the margin where it balances with utility, profit is unnecessary; indeed, in the long run of neoclassical economics profit disappears through the action of competition. At the price-determining margin the essential services of the productive factors are rewarded through wages to labor, interest to capital, rent to land, and wages of management to entrepreneurs, without any residual balance identified economically as profit.

In this pattern of economic analysis cost is price oriented. Price is viewed as the market exchange value which demand must support to induce the supply at the margin. The price-determining margin is thus the focal point of the essential costs. Any excess of price above these costs gives rise to a pure profit, an economic surplus, that cannot endure; any excess of the costs above price creates a pure loss, an economic deficit, that will be short-lived. It is fundamental in this approach that economic cost encompasses those service rewards regarded as essential at the point of marginal pricing equilibrium.

The economic concept of profit as a surplus, or residuum, is basic as a complement to economic cost. The relevance emerges in a consideration of risk, a factor of continuing import in cost-of-capital analysis, and broadly identified as potential adversity, largely from an income standpoint. For this purpose risk may be recognized in three categories: (1) that which is measurable and by the insurance process is transformed into cost, thus eliminating the risk; (2) that which is statistically immeasurable, yet enters into anticipations through decision-making; and (3) that which cannot be anticipated.[1] The measurable uncertainties lose their risk status, largely by application of the law of large numbers through insurance to transform them into cost certainty, usually supported by contract. The anticipated, but statistically unverified, risk, as represented by the premium above pure interest in the earnings yield of common shares, must be compensated in the long run if the essential proprietary funds and entrepreneurship are to be provided. In this sense, even in the economic literature, profit has been described as a reward for the service of risk-bearing. Yet, profit in this sense compensates essential productive service, and thus qualifies as economic cost rather than as pure profit or true economic surplus.

Beyond the "insured" and anticipated risks, however, are enterprise uncertainties and hazards that defy pre-

Paul M. Van Arsdell is Professor of Finance and head of the Department of Finance at the University of Illinois. He was president of the American Finance Association in 1960, and is now a member of the Advisory Committee and a director of that Association. He has contributed articles to numerous professional journals. His field of primary interest is corporation finance.

1. Footnotes at end of article.

The CFA Institute is collaborating with JSTOR to digitize, preserve, and extend access to Financial Analysts Journal
www.jstor.org

Log in via your institution

Acc

Log i

Resto

Restore content access for purchases made as guest

About Cookies On This Site

We and our partners use cookies to enhance your website experience, learn how our site is used, offer personalised features, measure the effectiveness of our services, and tailor content and ads to your interests while you navigate on the web or interact with us across devices. You can choose to accept all of these cookies or only essential cookies. To learn more or manage your preferences, click "Settings". For further information about the data we collect from you, please see our Privacy Policy

Accept All

Essential Only

Settings

Purchase options *

Save for later

PDF download + Online access

- 48 hours access to article PDF & online version
- Article PDF can be downloaded
- Article PDF can be printed

USD 53.00

Add to cart

Issue Purchase

- 30 days online access to complete issue
- Article PDFs can be downloaded
- Article PDFs can be printed

USD 162.00

Add to cart

* Local tax will be added as applicable

Related Research

Recommended articles | Cited by

About Cookies On This Site

We and our partners use cookies to enhance your website experience, learn how our site is used, offer personalised features, measure the effectiveness of our services, and tailor content and ads to your interests while you navigate on the web or interact with us across devices. You can choose to accept all of these cookies or only essential cookies. To learn more or manage your preferences, click “Settings”. For further information about the data we collect from you, please see our Privacy Policy

Accept All

Essential Only

Settings

Information for

Authors
R&D professionals
Editors
Librarians
Societies

Open access

Overview
Open journals
Open Select
Dove Medical Press
F1000Research

Opportunities

Reprints and e-prints
Advertising solutions
Accelerated publication
Corporate access solutions

Help and information

Help and contact
Newsroom
All journals
Books

Keep up to date

Register to receive personalised research and resources by email

Sign me up

Copyright © 2024 Informa UK Limited Privacy policy Cookies Terms & conditions

Accessibility

Taylor & Francis Group
an informa business

Registered in England & Wales No. 3099067
5 Howick Place | London | SW1P 1WG

About Cookies On This Site

We and our partners use cookies to enhance your website experience, learn how our site is used, offer personalised features, measure the effectiveness of our services, and tailor content and ads to your interests while you navigate on the web or interact with us across devices. You can choose to accept all of these cookies or only essential cookies. To learn more or manage your preferences, click “Settings”. For further information about the data we collect from you, please see our Privacy Policy

Accept All

Essential Only

Settings