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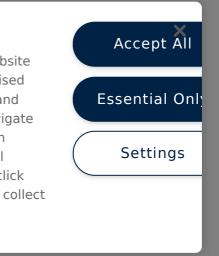
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Viewpoint of Financial Management

Considerations Underlying Cost of Capital

by Paul M. Van Arsdell

OST 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.

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 en-deavor to the satisfaction of wants under profit objec-tive; 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. Accord-ingly, the managerial viewpoint is properly conditioned by economic, accounting, legal, and financial consider-ations with substantial reciprocity as well as divergence among the respective associated approaches. The reciprocity and divergence of approach are logi-

among the respective associated approaches. The reciprocity and divergence of approach are logi-cally inherent in an analysis of cost of capital. Both cost and capital are terms widely employed in the litera-ture 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 re-spective 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. 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 founda-tion. 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-

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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 re-warded through wages to labor, interest to capital, rent to land, and wages of management to entrepreneurs, without any residual balance identified economically as profit

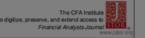
profit. In this pattern of economic analysis cost is price oriented. Price is viewed as the market exchange value which demand must support to induce the supply at the margin. The price-determining margin is thus the focal point of the essential costs. Any excess of price above these costs gives rise to a pure profit, an economic sur-plus, 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 conomic cost encompasses those service rewards re-garded as essential at the point of marginal pricing equilibrium.

commic cost encompasses those service rewards re-garded 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, as 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 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 pumbers through insurance to transform them into cost certainty, usually supported by contract. The antici-pated, but statistically unverified, risk, as represented by the premium above pure interest in the earnings yield of the essential proprietary funds and entrepreneurship are to be provided. In this sense, even in the conomic statistic of risk-bearing. Yet, profit in this sense compen-sates essential productive service, and thus qualifies as conomic cost rather than as pure profit or true eco-nomic surplus.

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

1. Footnotes at end of article.

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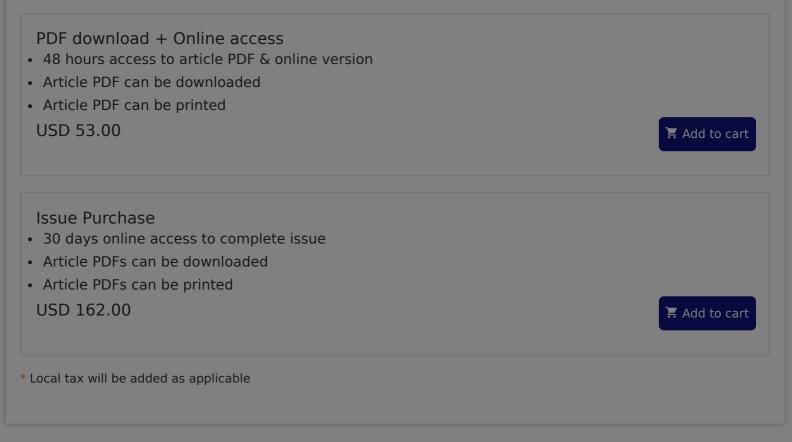
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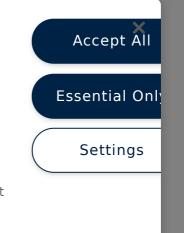
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