COST OF CAPITAL

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Cost of Capital

- Cost of capital is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds.
- Cost of capital is the required rate of return on its investments which belongs to equity, debt and retained earnings.
- If a firm fails to earn return at the expected rate, the market value of the shares will fall and it will result in the reduction of overall wealth of the shareholders.
- According to the definition of Solomon Ezra, "Cost of capital is the minimum required rate of earnings or the cut-off rate of capital expenditure".

Assumption of Cost of Capital

- It is to be considered that there are three basic concepts:
- It is not a cost as such. It is merely a hurdle rate.
- It is the minimum rate of return.
- It consist of three important risks such as zero risk level, business risk and financial risk.

Cost of capital can be measured with the help of the following equation.

$$K = rj + b + f.$$

Where,

K = Cost of capital.

rj = The riskless cost of the particular type of finance.

b = The business risk premium.

f = The financial risk premium.

CLASSIFICATION OF COST OF CAPITAL

- Cost of capital may be classified into the following types on the basis of nature and usage:
- Explicit and Implicit Cost.
- Average and Marginal Cost.
- Historical and Future Cost.
- Specific and Combined Cost.

Classification of Cost

- Explicit cost is the rate that the firm pays to procure financing.
- Implicit cost is the rate of return associated with the best investment opportunity for the firm and its shareholders that will be forgone if the projects presently under consideration by the firm were accepted.
- Average cost of capital is the weighted average cost of each component of capital employed by the company. It considers weighted average cost of all kinds of financing such as equity, debt, retained earnings etc.
- Marginal cost is the weighted average cost of new finance raised by the company. It is the additional cost of capital when the company goes for further raising of finance.
- Historical cost is the cost which as already been incurred for financing a particular project. It is based on the actual cost incurred in the previous project.
- Future cost is the expected cost of financing in the proposed project. Expected cost is calculated on the basis of previous experience.

Classification of Cost of Capital

- The cost of each sources of capital such as equity, debt, retained earnings and loans is called as specific cost of capital. It is very useful to determine the each and every specific source of capital.
- The composite or combined cost of capital is the combination of all sources of capital. It is also called as overall cost of capital. It is used to understand the total cost associated with the total finance of the firm.

IMPORTANCE OF COST OF CAPITAL

- **Importance to Capital Budgeting Decision**
- Capital budget decision largely depends on the cost of capital of each source. According to net present value method, present value of cash inflow must be more than the present value of cash outflow.
- Hence, cost of capital is used to capital budgeting decision.
- **Importance to Structure Decision**
- Capital structure is the mix or proportion of the different kinds of long term securities. A firm uses particular type of sources if the cost of capital is suitable.
- Hence, cost of capital helps to take decision regarding structure.

Importance of Cost of Capital

- **Importance to Evolution of Financial Performance**
- Cost of capital is one of the important determine which affects the capital budgeting, capital structure and value of the firm. Hence, it helps to evaluate the financial performance of the firm.
- **Importance to Other Financial Decisions**
- cost of capital is also used in some other areas such as, market value of share, earning capacity of securities etc. hence, it plays a major part in the financial management.