FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM V SEM.

SUBJECT: INTRODUCTION TO FINANCIAL MANAGEMENT

SUBJECT CODE: BCH 505

LECTURE: 19

NAME OF FACULTY: DR. PALASH BAIRAGI

LECTURE-19

2.3 COST OF CAPITAL

The cost of capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by the firm. The capital used by the firm may be in the form of debt, preference capital, retained earnings and equity shares. The concept of cost of capital is very important in the financial management. Cost of capital for a firm may be defined as the cost of obtaining funds i.e., the average rate of return that the investors in a firm would expect for supplying funds to the firm.

According to Solomin Ezra: “Cost of capital is the minimum required rate of earning or the cut-off rate of capital expenditure.”

According to Jhon J: **“**The rate of return the firm requires from investment in order to increase the value of the firm in then market place.”

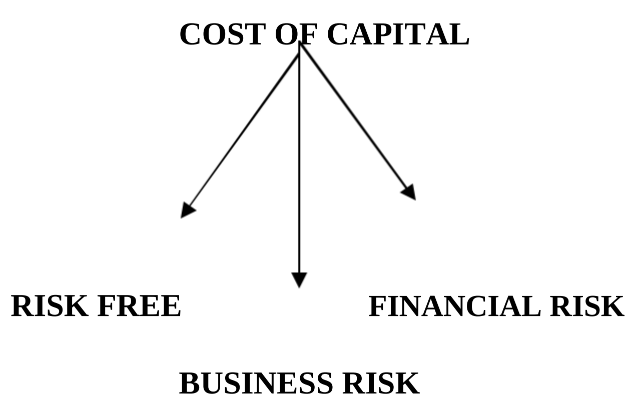
Features of Cost of capital

- Cost of capital is not a cost as such. In fact, it is the rate of return that a firm requires earning from its projects.
- It is the minimum rate of return. Cost of Capital of a firm is that minimum rate of return, which will at least maintain the market value of the firm.
- It comprises of three elements.

K = r + b + f + o

Where,

K= cost of capital
r = The expected normal rate of return at zero risk
level b= premium for business risk f = premium for
finance risk
o =other risk



5.3.1 Significance of Cost of Capital

As Acceptance Criteria in Capital Budgeting: The concept of cost of capital has assumed growing importance largely because of the needs to devise a rational mechanism for making the investment decision of the firm. Considering the fosyof capital can make capital budgeting decisions. According to the present value method of capital budgeting, if the present value of expected returns from investment is greater than or equal to the cost of investment, the project may be accepted, otherwise it may be rejected.

As a Determinant of Capital Mix in Capital Structure Decisions: Financing the firm asset is the very crucial problem in every business and as a general rule there should be a proper mix of debt and equity capital in financing the firm's assets. While designing the optimal capital structure, the management g\has to keep in mind the on\objective of maximizing the value of the firm and min9imising the cost of capital.

As a Basis for Evaluating the Financial Performance: The concept of cost of capital can be used to evaluate the financial performance of the top management. The actual profitability of the project is compared the projected overall cost of capital and the actual cost of capital of funds rise to finance the project if the actual profitability of the project is mort than the projected.

As the Basis for taking other Financial decisions: The cost of capital is also used in making other financial decisions such as dividend policy, capitalization of profits, making the right issue and working capital.