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.

CLASSIFICATION OF COST OF CAPITAL

- Explicit and Implicit Cost.
- Average and Marginal Cost.
- Historical and Future Cost.
- Specific and Combined Cost.

Explicit and Implicit 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 and Marginal Cost: 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 and Future Cost: 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.

Specific and Combine Cost: 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 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.