

Department of Commerce (CA)

B. Com (CA) - VI Semester - 2018-2021 Batch

Financial Management - 18 BCA 62C

Book: - Financial Management - Dr. V.R. Palanivelu

UNIT - II

Cost of Capital - Meaning and Importance
- Cost of debt, preference, equity and retained earnings - Weighted Average Cost of Capital.

Meaning of Cost of Capital :-

It is the minimum rate of return a firm can earn on its investment. It is expected by its investors has a direct relation with risk involved in the organization.

Definition :-

"Cost of Capital is the minimum required rate of earnings or the cut-off rate of capital expenditure."

- Solomon Ezra.

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Importance of Cost of Capital :-

1. Determination of Capital Budgeting decisions.
2. To assist Capital Structure Decisions.
3. To assist Project Expansion
4. To evaluate the Financial Performance
5. Basis for taking other Financial decisions

Features of Cost of Capital :-

1. Minimum Rate of Return
2. Related with Long term Funds.
3. Basis on the Actual cost.

Types / Classification of Cost of Capital

- I. Cost of Debt.
- II. Cost of Preference Shares.
- III. Cost of Equity Shares.
- IV. Cost of Earnings.

Cost of Debt: -

The cost of debt is the effective interest rate of a company pays on its debts

$$K_d = \frac{\text{Annual Interest}}{\text{Net Proceeds}} \times 100$$

Prob. No. 1:- X - Ltd issued Rs. 50,000

8% debentures at i) par, ii) at premium 10%,
iii) at a discount 10%. The tax rate is 50%.
Compute the cost of debt capital.

Cost of Preference Shares: -

An amount paid by company as dividend to preference shareholder is known as cost of preference share capital.

$$K_p = \frac{\text{Preference Dividend}}{\text{Net Proceeds}} \times 100$$

Prob. No. 2:- A Co., raised preference share capital of Rs. 1,00,000 by issue at preference share of Rs. 10 each. Calculate cost of preference capital when they are i) at 10% premium ii) at 10% discount.

Cost of Equity Shares:-

It is the return a firm theoretically pays to its equity investors.

$$k_e = \frac{D_1}{MP} + G_1.$$

Prob. no. 3 :- The current market price of an equity shares of a company is Rs. 90 in case of dividend are expected to grow at the rate of 7%. The current DPS is Rs. 4.50. Find the cost of Equity share capital.

Cost of Retained Earnings:-

It is the cost to a corporation of funds that it has generated internally.

Weighted Average Cost of Capital:-

From the following capital structure of a Co., calculate the overall cost of capital using Book value weights Method.

	Book Value (₹)
Equity Share Capital (₹. 10 per share)	45000
Retained Earnings	15000
Preference Share Capital	10000
Debentures	30000

The after-tax cost of different source of finance :- Equity Share Capital = 14% ; Retained earnings = 13% ; Preference Share Capital = 10% ; Debentures = 5%.