E-CONTENT PREPARED BY

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NAAC Accredited "A" Grade College

(Recognized under Section 2(f) and 12(B) of UGC Act 1956)

E-Content prepared for students of

B.Com. Honours and Honours and Programme (Semester-6th) in Accounting

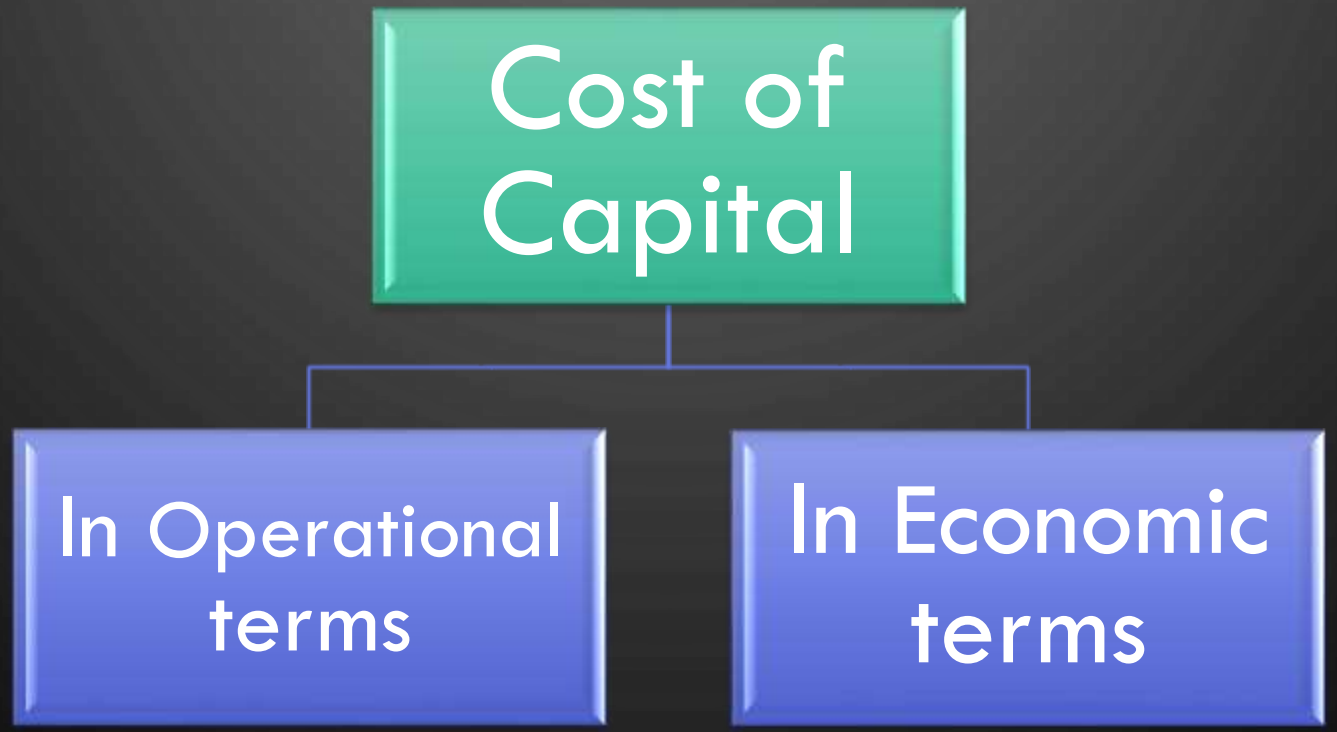
Name of Course: Financial Management

Topic of the E-Content

Cost of Capital

COST OF CAPITAL

COST OF CAPITAL: MEANING



IN OPERATIONAL TERMS

- COST OF CAPITAL IS DEFINED AS THE DISCOUNT RATE THAT WOULD BE USED IN DETERMINING THE PRESENT VALUE OF THE ESTIMATED FUTURE COST PROCEEDS AND EVENTUALLY DECIDING WHETHER THE PROJECT IS WORTH UNDERTAKING OR NOT.

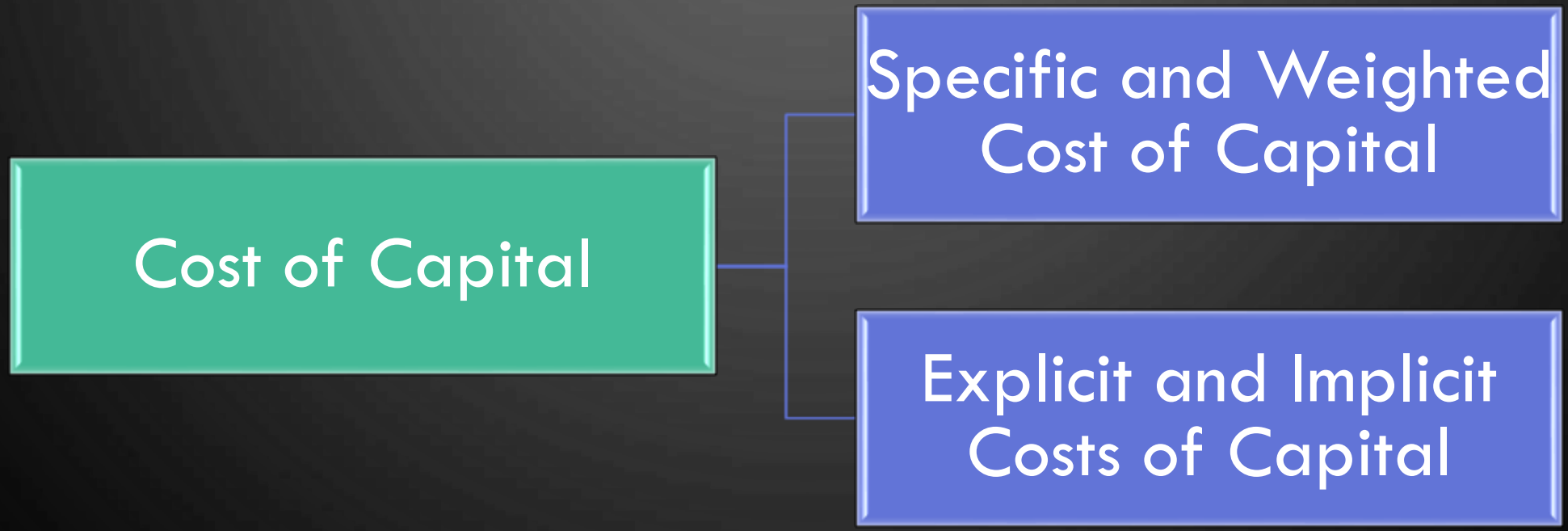
IN ECONOMIC TERMS

- COST OF CAPITAL REPRESENTS THE OPPORTUNITY COST OF FUNDS TO BE INVESTED IN A PROJECT WHERE THE OPPORTUNITY COST IS QUANTIFIED BY THE MAXIMUM EXPECTED RATE OF RETURN FROM THE NEXT BEST ALTERNATIVE FORGONE.

RELEVANCE OF COST OF CAPITAL

- Helpful in capital Budgeting
- Helpful in capital structure decisions
- Helpful in evaluating the financial performance
- Basis for other financial decisions like dividend policy, working capital decisions etc.

CLASSIFICATION OF COST OF CAPITAL



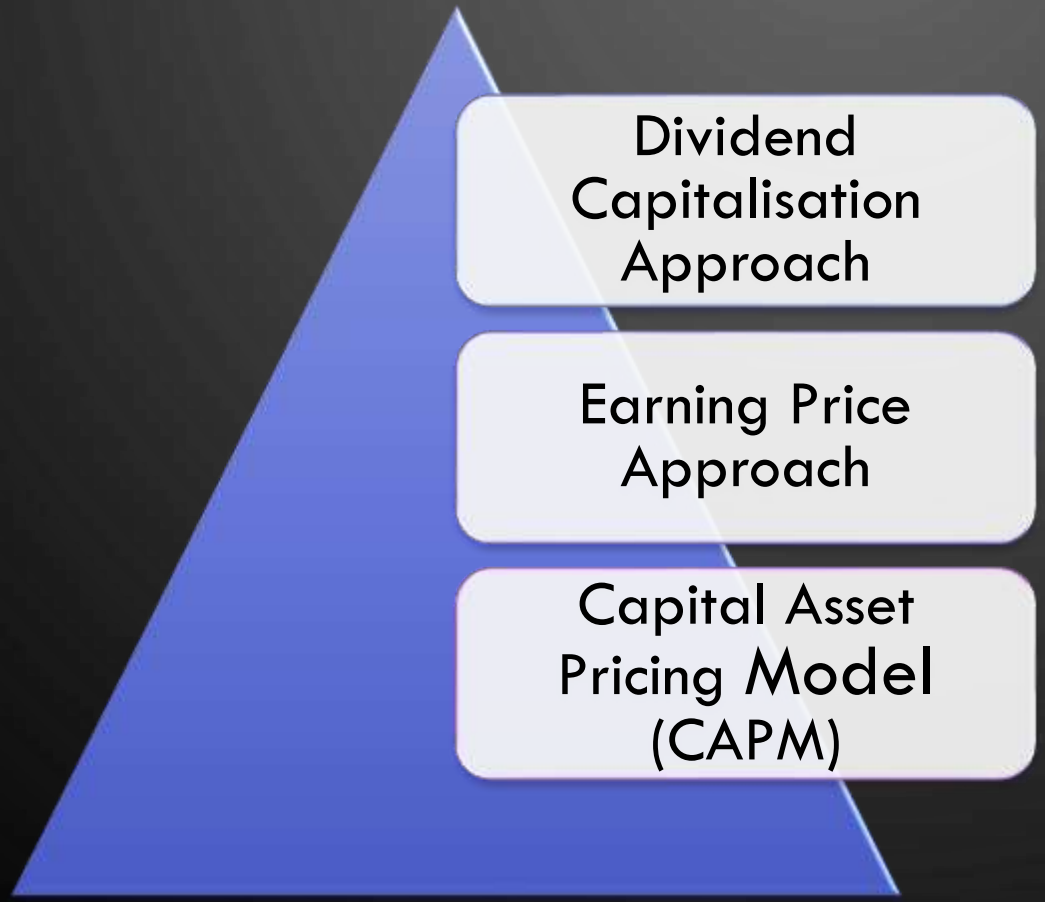
COST OF DEBT CAPITAL

Perpetual Debt	Redeemable Debt
Cost of Debt	
$K_d = \frac{I}{P}(1-t)$	$K_d = \frac{I(1-t) + \frac{1}{n}(F-P)}{\frac{1}{2}(F+P)}$

COST OF PREFERENCE SHARE CAPITAL

Redeemable Preference Share	Irredeemable Preference Share
Cost of Preference Share	
$K_p = \frac{D + \frac{(F - P)}{n}}{\frac{(P + F)}{2}}$	$K_p = \frac{D}{P}$

COST OF EQUITY CAPITAL



DIVIDEND CAPITALIZATION APPROACH

No Growth

- $K_e = \frac{D}{P}$

Constant Growth

- $K_e = g + \frac{D(1+g)}{P}$

EARNING PRICE RATIO APPROACH

No Growth

- $K_e = \frac{E}{P}$

Constant Growth

- $K_e = g + \frac{E(1+g)}{P}$

CAPITAL ASSET PRICING MODEL

CAPM

- $K_e = R_f + \beta(K_M - R_f)$

COST OF RETAINED EARNINGS

$$K_r = K_e(1 - t)(1 - b)$$

OVERALL COST OF CAPITAL

$$K_o = K_e w_1 + K_r w_2 + K_p w_3 + K_d w_4$$


END
Thank you for your attention
Any Questions ?