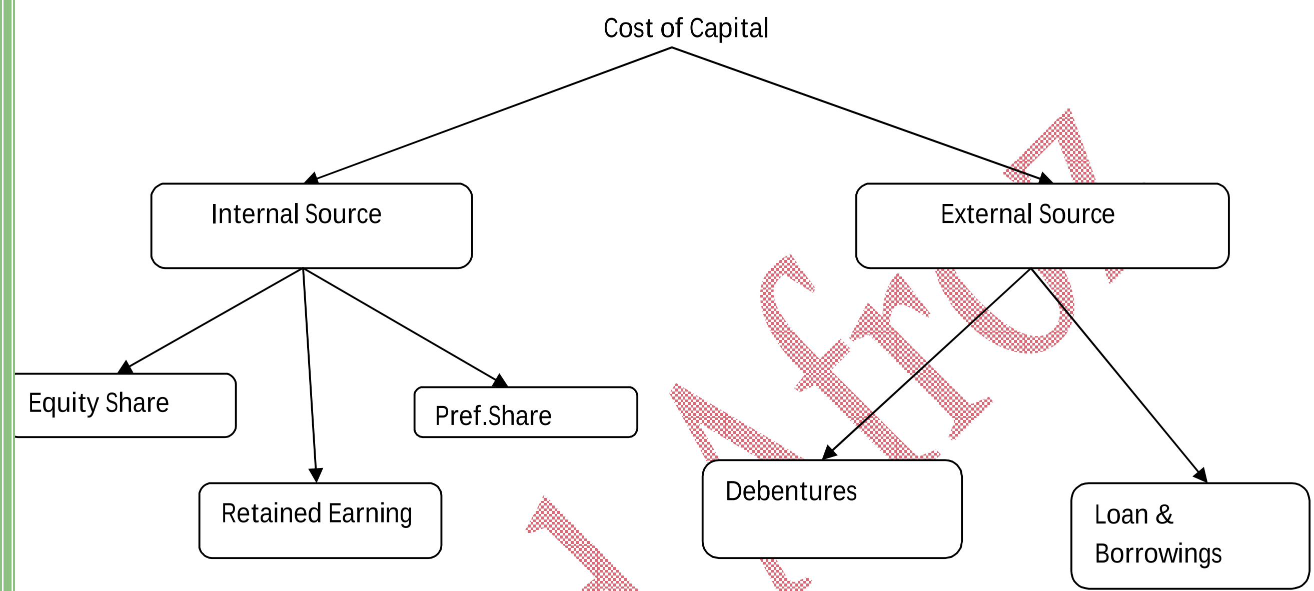
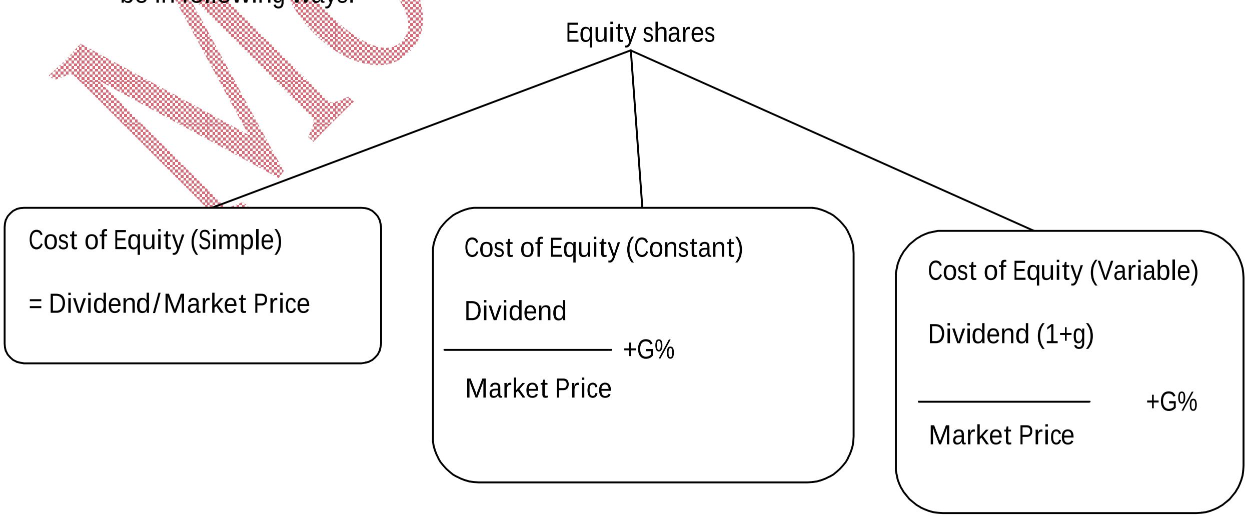
Cost of Capital

Organization raises funds from so many internal and external sources. While, organization raise the funds, he also liable to bear some cost of that funds. In other words cost of Capital is combination of Debenture, Equity shares, Pref.Shares and borrowing etc.



Internal Source

1. Equity shares: Its first internal source of raising fund. Computation of Cost of Equity (K_e) may be in following ways:



2. Retained Earnings : cost of retained earnings will be equal to Cost of Equity (K_e).where the involvement of personal income Tax, in this case cost of retained Earnings will be(K_e)*(1-tax).
3. Preference share :Cost of preference share (K_p) may calculate on redeemable and irredeemable basis

In case of Redeemable

$$= \frac{\text{Dividend} + \dfrac{\text{RV-NP}}{\text{No.of Years}}}{\text{RV+NP/2}} *100$$

In case of Irredeemable =Dividend/Market price *100

External Sources

Business may raise fund through the Debentures and Loan etc.Cost of raising fund through such types of sources is always high.

1. Debentures: cost of Debenture (K_d) may calculate on redeemable and irredeemable basis

In case of Irredeemable =Interest (1-Tax)/Net Proceed *100

In case of Redeemable

$$= \frac{\text{Interest (1-Tax)} + \dfrac{\text{RV-NP}}{\text{No.of Years}}}{\text{RV+NP/2}} *100$$

2. Loan & borrowings: Cost of Loan & borrowings may by calculated by the following formula :

=Interest (1-tax)

In case of Pref.Shares

NP = Net proceed = Par value of Pref. share capital – discount – cost of floatation

Or NP = Par value of pref. share capital + Premium

RV= Redeemable value

In case of Debentures

NP = Net proceed = Par value of Debenture – discount – cost of floatation

Or NP = Debenture + Premium

Format of WACC

1	2	3 =	4	5=3*4
Items	Amount	Proportion	Cost	WACC
Equity Share	--------------	=T.Amount/E.share	Cal.as above	3*4
Pref. Share	--------------	=T.Amount/P.share	Cal.as above	3*4
Retained earning	--------------	=T.Amount/R.Earn	Cal.as above	3*4
Debentures	--------------	=T.Amount/Deb.	Cal.as above	3*4
Loan	--------------	=T.Amount/Loan	Cal.as above	3*4
			Total	-----------------