

Discussion analyzing cost of capital

Finance



Analyzing Cost of Capital The cost of capital is the price the company pays to obtain and retail finance. The major decision for company as concern capital structure is to determine the ideal amount to use for debt and equity in order to attain a perfect capital structure, and consequently minimize the cost of capital.

The company needs to determine the best proportion of equity and debt that will keep the cost of capital at minimum, and which can be effectively managed by the firm. The overall cost of capital is measured by the weighted average cost of capital (W. A. C. C). It's a measure of the total cost to the enterprise for maintaining the current capital structure (Rosemary, 2012). In order to reduce this and attain an optimum capital structure the firm needs to determine the combinations of equity and debt that minimize the W. A. C. C. The effective use of that capital should also be considered, as there would be no need of accumulating large amounts of capital without necessary considerations of the projects that are supposed to be undertaken.

The company should also consider the cost of raising the particular capital that it deems appropriate. This is measured by the marginal cost of capital. . To obtain finance a company will pay implicit costs which are commonly known as floatation costs (Rosemary, 2012). These include: Underwriting commission, Brokerage costs, cost of printing a prospectus, Commission costs, legal fees, audit costs, cost of printing share certificates, advertising costs etc. For debt there are legal fees, valuation costs (i. e. security, audit fees, Bankers commission etc.). The company needs to determine the combination of capital items that will minimize to a large extent the marginal cost of capital (M. C. C).

The company also needs to consider leverage. This is the amount of debt used to finance a firm's assets. A firm with significantly more debt than equity is considered to be more leveraged. A high degree of leverage increases the financial risk the company faces, as it may not be able to refinance such debt, leading to insolvency (Rosemary, 2012). An optimum capital structure needs has lower amounts of financial risk and sustainable levels of leverage.

In conclusion, the capital structure selected by the company should minimize both the W. A. C. C and M. C. C, and maintain acceptable levels of leverage.

References

Rosemary, P. (2012). Cost of Capital for a Business. Retrieved from:
[http://bizfinance. about. com/od/cost-of-capital/a/overview-cost-of-capital-for-small-businesses. htm](http://bizfinance.about.com/od/cost-of-capital/a/overview-cost-of-capital-for-small-businesses.htm)