

Limitations of weighted average cost of capital as a method of investment apprais...

[Finance](#)



Limitations of WACC in investment appraisal

Despite its use in investment appraisal, there are various assumptions that are made when using WACC, hence, limiting its use in appraising investment (Student Account, 2008, p. 51). The first restrictive assumption that has to be met is that the investment project should be small compared to the investing organization. This, therefore, limits the use of WACC in appraising small investment but cannot be used when a small organization wants to acquire a large organization. The second limitation in the use of WACC is that the business activities of the investment project should be similar to those presently being undertaken by the investing organization. In light of this, a company cannot use WACC when appraising an investment to diversify its business activities.

Student Account (2008, p. 51) describes that when using the weighted average cost of the capital method in appraising an investment, the financing mix adopted to undertake the investment project must be similar to the present capital structure being used in the investment company. This, therefore, means that if a company uses shareholders money to finance its capital investment, it cannot rely on borrowed capital to make an investment. This, therefore, limits those companies that do not have adequate resources from using this method to appraise investments.

Student Account (2008, p. 51) further describes that when using a WACC, the existing providers of finance to the investing company will not change their required rates of return following the investment project that is being undertaken. This is, however, not possible since the rates keep changing following changes in the rates of inflation. In addition, the rates of return on

borrowed capital from banks change from time to time due to changes in the rate of interest. This also limits companies that may agree to reduce the number of dividends paid to shareholders from what is paid during the previous years to use these resources in an investment. This would not be possible when using WACC method to appraise an investment. Van Horne and James (2002, p. 43) explain that weighted average cost of capital as a method of appraising a project has the disadvantage of that care should be taken to select an appropriate income stream.

In conclusion, WACC can only be used as the discount rate on condition that the investment project will not change the risks of the business and the financial risks of the company undertaking an investment.