Fundamental elements of business

ASSIGN BUSTER

TOPIC: FINANCIAL MANAGEMENT INTRODUCTION: A business organization is familiar with such terms as cost of capital, cost of equity, shareholdersetc. these are the fundamental elements of any business organization, and such it's affairs as usual pivot around the significant terms. One of the factors used in checking, analyzing and in most cases considering a business organization at first glance is it's cost of capital which represent the foundation strength of a company. In calculating the cost of capital for any business organization - cost of equity and cost of debt are basically the ways involved in calculating it.

Definition of terms:

Cost of capital " this is the opportunity cost of the funds employed as a result of an investment decision"(Daniel Maxwell, 2004)it is the rate or return that a business could earn if it chose another investment risk.

Cost of debt; This is simply the interest rate a company is paying on all of it's

Debt such as loans and bonds.

Cost of Equity " is simply the rate of return required by a company's common stockholders"(Michael Heidegger 2002).

advantages of cost of Equity

Cost of equity does not necessarily involve repayment of funds raised unlike debt. It basically involves rising of funds through interests which not mount pressures on the organization. More pronounced is the fact that cost of equity gives the business organization a sense of expression which allows the organization room to go to all ends to acquire funds. They are not restricted by debt or anything.

Disadvantages of cost of equity.

If a company is successful, the higher the cost of equity which will definitely leave the company little. There is no stipulated cost of equity; it therefore depends on the interest rate which renders the company rather helpless. In this case the cost of equity of a company puts the organization in the position of always requiring votes from shareholders before taking certain decisions

Advantages of cost of debt

" wise use of debt may lower a firms weighted average cost of capital (WACC) during inflation debt is repaid with 'cheap dollars'". In this case raising debt capital is easier and less complicated because the company is not required to comply with state, federal security's laws and regulations.

Disadvantages of cost of debt

" Interest and principal must always be met when due regardless of a firms financial position, also poor use of debt may lower a firms stock price. It is interesting to note the fact that unlike equity debt must at some point be repaid."(Abraham M 98.)

In attempt to calculate the cost of capital for a firm -Danny's textile company. The following data represent the position and dealings of the company for a few years.

YEAR

RISK-FREE RATE

D . S

RETIAL PRICE

2005

6. 50%

4. 00%

1. 5%

2004

5. 20%

4. 00%

1. 00%

2003

4. 50%

3. 00%

1. 5%

Now in an attempt to calculate the cost of capital for Danny's company using, first, the cost of capital. The following formula is used since, since you must first consider pre-tax cost of debt which is; Risk free rate + default spread.

Which is = 6. 50% + 1. 50% = 8. 00% (1 - 0) = 8. 00%

The firm is paying no tax currently. Now cost of equity = tax free rate + default spread (4. 00%)

6. 50% + 1. 60 (4. 00%) = 12. 90%

Cost of debt = risk free rate + retail price (default spread)

6. 50 % + 1. 50 % (d. s) = 8. 00

Market value of debt = $ 349 mil (12%)

Market value of equity $84/ share x 340. 79 mil/share

= $28. 626mil (98. 8%).

Cost of capital is.

= 12. 9 % (. 988) + 8. 00 %(1 - 0) (. 012)

= 12. 84%

The above example displays the cost of capital of Danny's textile company

using cost of debt and cost of equity. However, in reaching or finding out the status of a company it is advisable to take a critical look at the following features in a company.

The cash flow; which reveals a company's amount of capital involved in the running of the company and the people involved.

The turn over; this is a statement of the current financial position of the company.

The profit a company makes over a period of time also informs a company's status of course if a company does not at the end of its year produce the amount of money it invested its in bad shape.

Effectiveness of the management, which is the competence of the management . the ability of the management to bring in new ideas for development. The question here is - when was the last time those managers brought in a working and successful idea.

REFERENCE

1. Daniel Maxwell. Capital Investments, new west publication company . 2004

2. Michael Heidegger financial management Gabnas press . Gabon. 2002.

3 Morgba Abraham investment plans aboki press makurdi . 98.