

Cost the market value
of the shares. (iii)



Cost of capital for a firm may be defined as the cost of obtaining funds, i. e., the average rate of return that the investors in a firm would expect for supplying funds to the firm. According to Hampton, John J “ Cost of capital is the rate of return the firm requires from investment in order to increase the value of the firm in the market place.”

Basic aspects of the cost of capital:

(i) Cost of capital is not a cost as such - In fact, it is the rate of return that a firm requires to earn from its projects.

(ii) It is the minimum rate of return-cost of capital of a firm is that minimum rate of return which will at least maintain the market value of the shares. (iii) It comprises of three components: (a) the expected normal rate of return at zero risk level, say the rate of interest allowed by banks. (b) the premium of business risk. (c) the premium for financial risk on account of pattern of capital structure. Cost of capital may be represented as: $K = r_0 + b + f$ where, K = cost of capital, r_0 = normal rate of return at zero risk level, b = premium for business risk, f = premium for financial risk.