**COST OF CAPITAL AND FINANCING DECISIONS**

The cost of capital is a minimum expected rate of return on an investment project. It is calculated as the total expected return on all capital sources of financing an investment which are mainly equity and debt. Cost of capital is therefore equal to the cost of equity plus the cost of debt plus cost of preference shares plus cost of debentures. A business firm should calculate its cost of capital as a benchmark to gauge against expected rates of return on investments. The expected rate of return on investments should not be less than the cost of capital.

CALCULATING THE COST OF CAPITAL

Calculating the cost of capital is achieved by calculating each component cost of capital using relevant formula.

Calculating cost of equity (COE) is done using mainly the capital asset pricing model (CAPM) and the growth model.

COE= CAPM = Rf + B (Rm – Rf) where;

Rf is the risk free rate of return or interest rate on a risk free government bond

B is beta sensitivity or sensitivity of the asset or share due to price changes in the market

Rm is the market return on the share

Ie CAPM= 0.2 + 0.1(0.3-0.2) = 0.21 or 21%

The calculated cost of equity also applies as the effective cost of retained earnings.

The cost of debt is calculated as an after tax component because debt is tax deductible as interest payments to creditors or debt providers are paid from profits or earnings before interest and tax before deducting the tax as opposed to dividend payment to shareholders which are paid after tax deductions before retaining earnings.

Cost of debt= (interest rate Rf + credit risk rate) (1-tax rate)

A rational investor would decide to use equity and retained earnings financing before considering debenture debt and preference share capital financing sources for the business firm.