## Question: Why cost of common stock is greater than cost of retained earning?

**Answer:** Cost of retained earnings is less than cost of equity capital because of two reasons- In case of retained earnings,

a) There is no flotation cost
b) Personal income tax can be considered

## Question: What is meant by Marginal Cost of Capital?

**Answer:** Marginal cost of capital is the weighted average cost of the last dollar of new capital raised by a company. It is the composite rate of return required by shareholders and debt-holders for financing new investments of the company. It is different from the average cost of capital which is based on the cost of equity and debt already issued.

## Question: 'Debt is the cheapest sources of funds'-Explain the statement.

**Answer:** Debt is considered as the cheapest sources of fund because of the following reason –

**Tax deductible expense** – interest on debt is tax deductible expense. The interest tax shield reduces the cost of debt as well as the overall cost of capital.

**Assurance of capital back** - there is a certainty that the amount of loan would be refunded by the firm to its lender after specific time period. That's why the rate of interest on debt is not so high.

**Certainty of income** - debt financing creates a binding or legal obligation on the firm to pay interest whether the firm can make profit or not. As this arrangement gives assurance to the lender for certain amount of return after a specific time period so the lenders are satisfied with the lower interest rate compared to other sources of funds.

**Participate in management** - common stock holders are the owners of the firm. So, they have the right to participate in management and firms activities. But the lenders of fund have no such kind of right. So there is no representative on behalf of the lender who can raise voice for their welfare.

### Question: "Equity capital is not free of cost" - Explain

**Answer:** *Equity capital is not free of cost because* – We know that equity capital involves an opportunity cost; ordinary shareholders supply funds to the firm in the expectation of dividends equal with their risk of investment. The market value of the share determined functioning capital market reflects the return required by ordinary shareholders. Thus, the shareholders required rate of return which equals the present value of the expected dividends with the market value of the share is the cost of equity. So we can say that the equity capital is not free of cost.

### Question: Why is the cost of financing a project with retained earnings less than the cost of financing it with a new issue of common stock?

**Answer:** Although common stock and retained earnings have the same investor's required rate of return, they do not have the same cost of capital. When new common stock is issued, the firm incurs flotation costs that reduce the cash proceeds the firm receives.

**Cost of new equity,**

$$Ke = \left(\frac{D1}{P0 - F} + g\right) \times 100$$

The cost of retained earnings is the opportunity cost of the stockholders. If the fund of retained earnings were paid out to the current stockholders as dividend, it can be reinvested. By doing this, stockholders could at least earn an equivalent return to that provided by their present investment in the firm on an equal risk basis, which can otherwise be called opportunity cost of the stockholders. When the firm retains earnings, no flotation costs are involved.

**Cost of new equity,**

$$K_r = (D_1 / P_0) + g$$

Because there are no flotation costs when earnings are retained, retentions have a lower cost of capital than new equity capital.

### Question: Why cost of capital is considered as a hurdle rate for new investment project?

**Answer:** The cost of capital for a firm is the minimum required rate of return for that firm. It is also known as the hurdle rate for a new investment project. It provides a yardstick to measures the worth of investment proposals and, performs the role of accept-reject criterion.

If a firm invests in a project whose expected rate of return is more than its cost of capital, then the project can be accepted as it would increase the wealth of the shareholders, the ultimate goal of a firm. Conversely, if a firm invests in a project whose expected rate of return is less than the cost of capital the wealth of the shareholders can be decreased. Thus the project should be rejected.

To take capital budgeting decision, the financial managers use several techniques. Among them NPV method and IRR method are prominent. These discounted cash flow techniques use the concept of cost of capital to determine a project's acceptability.

In the NPV method, an investment project is accepted if it has a positive NPV and rejected if the NPV is negative. In this sense, the cost of capital is discount rate used for evaluating the desirability of an investment.

In the IRR method, the investment project is acceptable if it has an internal rate of return greater than the cost of capital and rejected if internal rate of return is less than the cost of capital. In the context, the cost of capital is the minimum required rate of return on an investment project.

The cost of capital is the minimum required rate of return on the investment project that keeps the present wealth of shareholders unchanged. So, cost of capital is considered as a hurdle rate for new investment project

### Question: Should the company use the composite WACC as the hurdle rate for each of its projects?

No. The composite WACC reflects the risk of an average project undertaken by the firm. Therefore, the WACC only represents the "hurdle rate" for a typical project with average risk. Different projects have different risks. The project's WACC should be adjusted to reflect the project's risk.