RAMA UNIVERSITY

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FACULTY OF COMMERCE AND MANAGEMENT

COURSE: BBA III SEM.

SUBJECT: FINANCIAL MANAGEMENT

SUBJECT CODE: BBA 303

LECTURE: 23

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LECTURE-23

4. Cost of Retained Earnings:

The cost of retained earnings may be considered as the rate of return which the existing shareholders can obtain by investing the after tax dividends in alternatives opportunity of equal qualities. It is thus the opportunity cost of dividends foregone by the shareholders.

$$Kr = \left(\frac{D}{NP} + G \right) (1 - t)(1 - b)$$

Where, Kr = Ke (1-t) (1-b)
= Expected
Dividends G = Growth Rate
NP = Net Proceeds of equity issue
t = Tax rate
b = Cost of purchasing new securities
Ke = Rate of return available to shareholders.

Computation of Weighted Average Cost of Capital: Weighted average cost of capital is the average cost of various sources of financing. It is also known as Composite Cost of Capital, Overall Cost of capital, average accost of capital. Once the cost of specific source of capital is determined, weighted average cost of capital can be computed by putting weights to the specific costs of capital in proportion of the various sources of funds to the total. The CIMA defines the weighted average cost of capital " as the average cost of company's finance (equity, debentures, bank loans) weighted according to the proportion each elements bears to the total pool of capital, weighting is usually based on market valuation current yields and costs after tax."

Weights can be given in the following way:

Historical or existing weights

Book value weights
Market value weights

Marginal weights

Historical or existing weights: Historical or existing weights are the weights based on the actual or existing proportions of different sources in the overall capital structure. Such weighing system is based on the actual proportions at the time when the W ACC is being calculated. In other words, the weighing system is the proportions in which the funds have already been raised by the firm.

The use of historical weights is based on two important assumptions namely

That the firm would raise the additional resources required for financing the investment proposals, in the same proportions in which they are appearing at present in the capital structure, and

That the present capital structure is optimal and therefore the firm wants tocontinue with the same pattern in future also. However, there may be some problems in applying the historical weights. The firm may not be able to raise additional finance in the same proportion as existing one because of prevailing economic and capital market conditions, legal constraints or other factors.

Book Value Weights: The weights are said to be book value weights if the proportions of different sources are ascertained on the basis of the face values i.e., the accounting values. The book value weights can be easily calculated by taking the relevant information from the capital structure as given in the balance sheet of the firm.

The book value weights are considered as a sound weighing system as it is operational in nature and a firm may design its capital structure in terms of as it appears in the balance sheet. However, the book value weights system does not truly reflect the economic values. In fact, the weighing system should be market determined. The book value weights system is not consistent with the definition of the overall cost of capital, which is defined as the minimum rate of return needed to maintain the firm's market value. The book value weights ignore the market values.

Market Value Weights: The weights may also be calculated on the basis of the market value of different sources i.e., the proportion of each source at its market value. In order to calculate the market value weights, the firm has to find out the current market price of the securities in each category. However, a problem may arise if there is no market value available for a particular type of security.

The advantages of using the market value weights may be

The market value weights are consistent with the concept of maintaining market value in the definition of the overall cost of capital. The market value weights provide current estimate of the investor's required rate of return.

The market Value weights yield good estimate of the cost of capital that would be incurred should the firm require additional funds from the market.

However, the market values weights suffer from some limitations, as follows:

Not only that the market values of all types of securities issue have to be obtained but also that the market value of equity share is to be segregated into capital and retained earnings.

The market values are subject to change from time to time and so the concept of optimal capital structure in terms of market values does not remain relevant any longer. External

factors, which affect the market value, will affect the cost of capital also and therefore, the investment decision process will be influenced by the external factors.

The WACC based on market value will generally be greater than the WACC based on book values. The reason being that the equity capital having higher specific cost of capital usually has market value above the book value. However, this is not the rule.