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# Concept of Cost of Capital, Components & Significance of Cost of Capital : A Review

**Dr. Kulbir Singh**

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**Introduction :** Cost of capital is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds. Cost of capital is the required rate of return on its investments which belongs to equity, debt and retained earnings. If a firm fails to earn return at the expected rate, the market value of the shares will fall and it will result in the reduction of overall wealth of the shareholders.

**Concept of Cost of Capital**

There is bulk of finance literature to describe this concept. Numerous studies have shown that Cost of capital is the rate of return that a firm must earn on its project investments to maintain its market value and attract funds. It is the required rate of return on its investments which belongs to equity, debt and retained earnings. If a firm fails to earn return at the expected rate, the market value of the shares will fall and it will result in the decrease of overall prosperity of the shareholders. Famous theorist, John J. Hampton described cost of capital as "the rate of return the firm required from investment in order to increase the value of the firm in the market place". Solomon Ezra stated that "Cost of capital is the minimum required rate of earnings or the cut-off rate of capital expenditure" According to James C. Van Horne, Cost of capital is "A cut-off rate for the allocation of capital to investment of projects. It is the rate of return on a project that will leave unchanged the market price of the stock". Another theorist, William and Donaldson explained that "Cost of capital may be defined as the rate that must be earned on the net proceeds to provide the cost elements of the burden at the time they are due".

**Assumption of Cost of Capital**

It is documented in theoretical studies that cost of capital is based on some assumptions which are directly related while calculating and measuring the cost of capital. There are three basic concepts:
Cost of capital can be measured with the following equation:

$$\mathbf{K = r_j + b + f}$$

Where,
K = Cost of capital.
rj = The riskless cost of the particular type of finance.
b = The business risk premium.
f = The financial risk premium.