**EFFECTIVE FINANCIAL MANAGEMENT**

**Learning Outcome 4: ACTIVITY 5**

**Weighted average cost of capital**

The cost of capital also provides a ‘benchmark’ or ‘threshold’ against which investment opportunities (that will use the finance raised in order to generate profit) can be appraised. The costs of the individual sources of finance can be weighted according to their relative importance as sources of finance. This approach to the calculation of the cost of capital is known as the weighted average cost of capital (WACC) (pronounced ‘whack’).

Use this film the help to explain the WACC:

<https://www.youtube.com/watch?v=lVpH4kZZxBE>

Consider that Whitley plc is financed by a combination of debt and equity. The book value of equity is $3.5 million and it has 1.5 million shares outstanding. The shares are traded at $4 each. The rate of return demanded by its shareholders on equity is 12%. The value of Whitley plc’s outstanding debt is $2 million and the cost of debt is 8%. There is no corporate tax.

#### In small groups

Identify a business with which you are familiar. This could be a multinational company from which you have purchased goods/services, a business that owns your favourite brand or the business for which you work (or wish to work in the future).

Ideally this should be the business you chose earlier to re-visit throughout your classroom activities.

From your research:

1. Outline the components of the WACC. Identify how these components are incorporated into the formula for the calculation of the WACC.
2. Calculate the weighted average cost of capital for Whitley plc.
3. Identify and explain the advantages and disadvantages of the use of the WACC as a measure of a business’s cost of capital.
4. Prepare a short presentation on your findings.