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The Conceptions of The Cost of Capital in The Context of Corporate Management

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Abstract. Cost of capital is an interdisciplinary scientific category and it is a subject of research in many fields. It may be perceived as a decision parameter in the area of capital gaining and investing by companies, as a factor determining the value of investment projects and the whole company. It affects such areas of corporate management as capital budgeting, processes of fusions and takeovers, restructuring decisions. The cost of capital is the most important element in the process of corporate management, to the same extent as information about other costs it has influence on key board decisions concerning the selection of technology, the scale of economic activities, activity localization etc. In the face of the complexity of the problem examined, it was made a research problem. The objective of the paper is to analyze different conceptions of the cost of capital from the point of view of their significance in corporate management. The paper is a study of theoretical and cognitive character. The research was based on a systematic review of literature that provided the grounds for the synthesis of the views concerning the research problem.

Keywords: cost of capital, equity management.

1 INTRODUCTION

Cost of capital is an interdisciplinary scientific category, which is the subject of research in many fields. It is a very important term in economics, finance, management and other sciences. At the same time it is interpreted in a variety of ways, both in theory and in economic practice. The objective of the analysis conducted in this paper is to perform an overview of the theories referring to the issue of the cost of capital and confronting them with a practical approach to this problem on the basis of enterprise management. The conducted considerations will result in creating a precise conceptual apparatus for the needs of further research in this area. The paper is a study of theoretical and cognitive character. The research is based on the *systematic review* method – a systematic review of literature, on the grounds of which a synthesis of views concerning the research problem was made.

2 TERMS OF THE COST OF CAPITAL

'Capital' is one of the basic scientific terms which has many various definitions and interpretations. It is a subject of research conducted on the grounds of economy, management and finance sciences. It often goes beyond the borders of economic sciences to the grounds of social, legal, humanistic, technical and other sciences. Capital is perceived as a category corresponding to the goods owned (resources), used for conducting and development of economic activity (property or resource concepts) or for gathered savings (monetary concepts) (de Soto, 2002). Its basic feature is the ability to grow (Bernstein, 2007). This growth can take the form of profit, financial income (percentage), value added or other forms (Michalak, 2013).

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In the process of company management, capital is described in the form of property reported in the balance sheet of this subject in assets, and having its financing sources on the side of liabilities. In this context most often the company capital is divided into real capital (corresponding to corporate assets) and financial capital (reflected in liabilities). In the wider approach, capital of the company can be treated as a general set of resources at the disposal of a given subject and used for the purpose of conducting economic activity. In such case, apart from the resources given in the balance sheet of the company, off-balance sheet resources, such as goodwill, technologies, competencies and customer relationship are also taken into account.

In the course of discussion regarding the essence of capital one should not neglect relatively young categories of capital, emerging on the basis of management sciences and in other scientific disciplines. In this category, social capital, intellectual capital etc. should be listed. These categories do not often go only beyond the discipline of management sciences but also beyond economic sciences, while still remaining in a direct relationship with management and other economic categories. In economic studies more and more often such issues are taken up, especially in the context of the relation between innovativeness, company value and its social capital.

Different approaches towards capital are always accompanied by the term of its cost. The current understanding of the cost of capital is usually reduced to return on the invested capital. Literature defines the cost of capital as return on the invested capital expected by investors at a given level of risk (Duliniec, 2001). It is related to alternate cost, i.e. return on investment expected by the investors, which they forfeit by choosing a specific variant of actions and in that way forgoing other possibilities, available at that moment (Ogier, Rugman and Spicer, 2004). The cost of capital is also defined as a discount rate, i.e. the value of money in time, by the use of which the expected cash flows are calculated into present value for all investors who invested capital in the enterprise (Copeland, Koller and Murrin, 1997). The significance of risk in defining the cost of capital should be highlighted. Investments with the same level of risk have the same cost of capital (Byrka-Kita, 2008). According to this approach, the cost of capital stems from the relation between risk and return rate. The more risky is the activity of the company, the higher return rate it needs to generate and the higher the cost of capital is (Michalak and Nawrocki, 2015). The cost of capital is strictly related to the source of its origin and accompanies capital coming from every source. It can be expressed as interest rates for capital providers, dividends, other benefits or even the cost of lost opportunities. Because the cost of capital can take various forms, it should be differentiated from financial costs which are a narrower term (Zadora, 2004). Financial costs are an accounting category, encompassing interest rates from the received loans and liabilities, interest rates and interest on banking credits, discount rate on the price of own bonds and other costs related to acquiring capital, charged to income generated before taxation (Dobrucka and Berczyńska, 2002). Financial costs do not encompass the costs that do not decrease the basis for taxation and in particular, the cost of equity.

3 ROLE OF THE COST OF CAPITAL IN COMPANY MANAGEMENT

Cost of capital serves a very important role in company management. It is perceived as a factor determining company's economic value or its parts, value added for shareholders. Furthermore, it has influence on the decisions concerning capital gaining and investing in a company, specifying among others: net present value of investment projects, selection of financing sources (Basak and Pavlova, 2013). It also affects other areas of company management such as capital budgeting, processes of acquisition and fusion, restructuring decisions (Haley and Schall, 1978). Cost of capital is as important element of decision process as information about other costs, it has influence on key board decisions concerning the selection of technology, scale of economic activities, activity localization (Mas, Nicolau, and

Ruiz, 2006). In the area of practical company management, especially in the area of corporate financial management, cost of capital is used as (Duliniec, 2002; Bodie and Merton, 1991; Bennet, 1991; Janasz, 2010):
- discount rate enabling transformation of net future cash flow, expected from the particular assets, into present value of these assets,
- discount rate when calculating net present value of investment projects,
- discount rate characteristic for cash flows generated by merged enterprises in the processes of fusion and acquisition,
- threshold return rate in the process of investment undertaking assessment,
- return rate on equity in the process of economic value added estimation,
- assessment criterion of return rates on capital invested (as a minimal, acceptable return rate on investment undertaken in a company in order to maintain its stock market value),
- base for using modern assessment tools of present company activity, such as residual income or economic value added,
- support during dividing an organized part of enterprise (activity segment) within the frames of restructuring (Różański, 2006),
- measure in the area of transfer pricing and tax risk management.

These problems may be analyzed in the management sciences in several dimensions, perceived differently according to various criteria (Sudoł, 2012):
- type of organization – on the level of company management,
- type of management function – on the level of financial capital planning and gathering,
- type of process - on the level of basic process consisting in financing the basic company operating activity,
- type of the area of activity - on the level of company management,
- type of resources - on the level of financial resources,
- type of management levels – on the level of strategic management (applies to long-term capital) and operating management (short-term capital).

4 COST OF CAPITAL – PARAMETER OR MANAGEMENT INSTRUMENT?

The problem of the cost of capital has a complex character and wide range. This issue is connected with a very important methodological question that should be answered. Such question constitutes a methodological dilemma, in particular. It is about determining to what extent the company has influence on the cost of capital, whether it is an independent parameters in the accounts made in different circumstances (value pricing, return on investment etc.) or whether it is one of corporate management parameters. Parameter is defined as an economic quantity that the company cannot affect much (Włoszczowski, 2005), it is treated as independent (external) variable, that decisions and actions are adjusted to. Changing the parameter usually requires launching adapting processes in the company. An example of such parameters may be equilibrium price on a competitive market, exchange rates, stock quotes, interest rates in banks (Che and Sethi, 2014), tax rates.

Furthermore, instrument is perceived in contrary to parameter. It may be defined as an economic quantity shaped on purpose, that serves reaching the objectives set in the process of corporate management. Instrument consists of prices determined in the company, conditions of concluding agreements and incurring debts, cost level, dividend amount (Jonek-Kowalska, 2012a). Some researchers treat the cost of capital as an objective parameter, directly deriving from stock market. However, if we assume that the cost of capital is something more than just the return rate for investors on stock market, being risk premium for bearing non-diversified systematic risk, then it gains the features of instrument used in the process of corporate management. In a case when the cost of capital is analyzed through the prism of systematic risk (that the company has no influence on) and specific risk (that the company may shape), the cost of capital depends on managers and owners' decisions to some extent, who ultimately shape it due to the influence of the factors dependent from the company (generating specific risk) (Jonek-Kowalska, 2012b). Therefore, it may be assumed that when looking at the cost of capital through the prism of systematic risk we deal with a parameter. Instrumental approach to the cost of capital occurs when it transforms from an objective parameter of an account, external for the company, into a corporate management instrument, shaped not only by external factors (systematic risk) but also by internal factors, dependent from the company (specific risk). Instrumental understanding of the cost of capital consists in including the calculation of specific risk into the calculation methods. Taking management decisions in the areas of company activity, where risk is generated, translates into the cost of capital in this company.

5 CONCLUSIONS

To summarize, it should be emphasized that the cost of capital is an important category in both, economic theory and practice. It emerges in various areas of economic sciences, on the grounds of different scientific disciplines, its role is clearly highlighted in corporate management. Management sciences deal with foundation, functioning, transformation, development and cooperation of economic organizations, mostly companies (Centralna Komisja ds. Stopni i Tytułów, 2010). Capital is an accompanying element in each of the aforementioned areas. It is vital in financing company's assets which are the first equipment of the company launched, it determines its functioning through shaping its production capacity (manufacturing, trade, service), during conducting the activity it enables financing of development undertakings or even company's liquidation. It is not possible to create company value without capital of appropriate structure and cost. In relation with the role of capital in the process of sustainable and permanent company development, capital should be identified with an element determining the company's economic existence. Therefore, it is a research object in the area of management sciences.

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