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Does the Weighted Average Cost of Capital Describe the Real-World Approach to the Discount Rate?

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Abstract

Almost every capital budgeting textbook has a chapter on the weighted average cost of capital (WACC). Though this is theoretically satisfying, it does not describe how companies actually operate. The WACC calls for a balanced capital structure in which debt and equity are utilized at some predetermined percentage. The problem is that researchers have shown that firms try to avoid selling new shares whenever possible. This leads to the pecking order theory in which firms first use internal funds, then low-risk debt, then high-risk debt, and finally, as a last resort, new common stock. There is no attempt to balance the capital structure. This survey study basically confirms that approach.

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