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The Weighted Average Cost of Capital: A Caveat

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INTRODUCTION

The debate between the proponents of the weighted average cost of capital (henceforth WACCists) and the proponents of sequential marginal costing (henceforth sequentialists) is one of the most fundamental debates in engineering economy. This debate is unresolved and would seem to be the subject of an academic truce. The purpose of this paper is to show that the WACC is subject to serious reservations if used as a capital budgeting discount rate. The determination of the discount rate for capital budgeting must be consistent with the principles underlying the determination of the net cash flows of capital projects.

THE WEIGHTED AVERAGE COST OF CAPITAL

The WACCists argue that the firm should be viewed as an ongoing concern, and the discount rate should be calculated as a weighted average of the various types of finance it uses, regardless of the specific financing used to fund a particular capital project (Brigham 1985: 250), (Weston & Copeland 1986: 612), (Ben-Horim 1987: 144-146), (Van Horne 1980: 234), (Levy & Sarnat 1982: 408-409). WACCists assert that even though a specific source of finance with a known cost is used to fund a project, this cost of capital should not be used as the discount rate. They argue that the use of one source of finance affects the firm's ability to raise the same type of finance as well as other types of finance in terms of cost and risk, and that this effect, a "spill-over" effect, also occurs from the past to the present, and from the present to the future (Brigham, 1985: 250).

The weighted average cost of capital is calculated (Gitman 1988: 400):

$$WACC = \sum \Omega \mu, \text{ where}$$

Ω = percent of the total capital structure supplied by each source of finance;

μ = the cost of capital of each source of finance reflected on the firm's balance sheet.

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