Capitalisation

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Description of Module

Items	Description of Module
Subject Name	Law
Paper Name	Corporate Finance
Module Name /Title	Capitalisation
Module No.	II

Capitalisation

Objective: After reading this module, the learners will have a clear picture of :

(i) Studies the capital structure of Organisation. They have to modify or revise their financial structure either by issuing more securities or by reducing the capital in order to make capitalization a reasonable one.

Learning Outcomes:

The basic concept of Finance is Capital. In accounting view it has been regarded as Asset and Liability or property. But the meaning of capitalization as per corporate finance capital includes stock and Debt.

Introduction:

Meaning of Capitalization: The ordinary meaning of the capital is the calculation or estimation of present value. It was used the sense of Valuation and amount. The study of capitalization involves three aspects: I .Amount of Capital ii Composition or form of Capital iii. Changes in Capitalisation. Capitalization comprises of share capital, debentures, loans, free reserves,etc. Capitalization represents permanent investment in companies excluding long-term loans.

Types of Capitalisation:

Amount of Capital(Normal Capitalisation): Studies the capital structure of Organisation.They have to modify or revise their financial structure either by issuing more securities or by reducing the capital in order to make capitalization a reasonable one. There are two aspects:

I Cost concept: The value of a corporation here is determined by the amount of promotion expenses, organization expenses, cost of fixed assets, working capital etc.

Ii Earning Concept: To evaluate the capitalization the earnings and Capital Investment complement each other and are mutually dependent.

Overcapitalization: Overcapitalization is a situation in which actual profits of a company are not sufficient enough to pay interest on debentures, on loans and pay dividends on shares over a period of time. This situation arises when the company raises more capital than required. A part of capital always remains idle. With a result, the rate of return shows a declining trend. The causes can be-

1. **High promotion cost-** When a company goes for high promotional expenditure, i.e., making contracts, canvassing, underwriting commission, drafting of documents, etc. and the actual returns are not adequate in proportion to high expenses, the company is over-capitalized in such cases.
2. **Purchase of assets at higher prices-** When a company purchases assets at an inflated rate, the result is that the book value of assets is more than the actual returns. This situation gives rise to over-capitalization of company.
3. **A company's floatation n boom period-** At times company has to secure it's solvency and thereby float in boom periods. That is the time when rate of returns are less as compared to capital employed. This results in actual earnings lowering down and earnings per share declining.
4. **Inadequate provision for depreciation-** If the finance manager is unable to provide an adequate rate of depreciation, the result is that inadequate funds are available when the assets have to be replaced or when they become obsolete. New assets have to be purchased at high prices which prove to be expensive.
5. **Liberal dividend policy-** When the directors of a company liberally divide the dividends into the shareholders, the result is inadequate retained profits which are very essential for high earnings of the company. The result is deficiency in company. To fill up the deficiency, fresh capital is raised which proves to be a costlier affair and leaves the company to be over- capitalized.
6. **Over-estimation of earnings-** When the promoters of the company overestimate the earnings due to inadequate financial planning, the result is that company goes for borrowings which cannot be easily met and capital is not profitably invested. This results in consequent decrease in earnings per share.

Effects of Overcapitalization

1. **On Shareholders-** The over capitalized companies have following disadvantages to shareholders:
   a. Since the profitability decreases, the rate of earning of shareholders also decreases.
   b. The market price of shares goes down because of low profitability.

c. The profitability going down has an effect on the shareholders. Their earnings become uncertain.
d. With the decline in goodwill of the company, share prices decline. As a result shares cannot be marketed in capital market.

2. **On Company-**

   a. Because of low profitability, reputation of company is lowered.
   b. The company’s shares cannot be easily marketed.
   c. With the decline of earnings of company, goodwill of the company declines and the result is fresh borrowings are difficult to be made because of loss of credibility.
   d. In order to retain the company’s image, the company indulges in malpractices like manipulation of accounts to show high earnings.

3. **On Public-** An overcapitalized company has got many adverse effects on the public:

   a. In order to cover up their earning capacity, the management indulges in tactics like increase in prices or decrease in quality.
   b. Return on capital employed is low. This gives an impression to the public that their financial resources are not utilized properly.
   c. Low earnings of the company affects the credibility of the company as the company is not able to pay it’s creditors on time.
   d. It also has an effect on working conditions and payment of wages and salaries also lessen.

Undercapitalization

An undercapitalized company is one which incurs exceptionally high profits as compared to industry. An undercapitalized company situation arises when the estimated earnings are very low as compared to actual profits. This gives rise to additional funds, additional profits, high goodwill, high earnings and thus the return on capital shows an increasing trend. The causes can be-

1. **Low promotion costs**
2. **Purchase of assets at deflated rates**
3. **Conservative dividend policy**
4. **Floatation of company in depression stage**
5. **High efficiency of directors**
6. **Adequate provision of depreciation**
7. **Large secret reserves are maintained.**

Efffects of Under Capitalization

1. **On Shareholders**
   a. Company's profitability increases. As a result, rate of earnings go up.
   b. Market value of share rises.
   c. Financial reputation also increases.
   d. Shareholders can expect a high dividend.
2. **On company**

   a. With greater earnings, reputation becomes strong.
   b. Higher rate of earnings attract competition in market.
   c. Demand of workers may rise because of high profits.
   d. The high profitability situation affects consumer interest as they think that the company is overcharging on products.
3. **On Society**

   a. With high earnings, high profitability, high market price of shares, there can be unhealthy speculation in stock market.
   b. 'Restlessness in general public is developed as they link high profits with high prices of product.
   c. Secret reserves are maintained by the company which can result in paying lower taxes to government.
   d. The general public inculcates high expectations of these companies as these companies can import innovations, high technology and thereby best quality of product.

Form of Capital:

Composition: Capitalization is composition of various kinds of securities like equity, Debenture and Bonds.