Capitalization

Meaning:

The objective of every business is to maximize the value of the business. In this respect the finance manager, as well as individual investors, want to know the value created by the business. The value of business relates to the capitalization of the business.

The need for capitalization arises in all the phases of a firm's business cycle. Virtually capitalization is one of the most important areas of financial management. In this article we will discuss various aspects relating to capitalization.

Concept of Capitalization:

Capitalization refers to the valuation of the total business. It is the sum total of owned capital and borrowed capital. Thus it is nothing but the valuation of long-term funds invested in the business. It refers to the way in which its long-term obligations are distributed between different classes of both owners and creditors. In a broader sense it means the total fund invested in the business and includes owner's funds, borrowed funds, long term loans, any other surplus earning, etc. Symbolically:

Capitalization = Share Capital + Debenture + Long term borrowing + Reserve + Surplus earnings.

Types of Capitalization:

Capitalization is generally found to be of following types-

1. Normal
2. Over
3. Under

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:
    1. Since the profitability decreases, the rate of earning of shareholders also decreases.
    2. The market price of shares goes down because of low profitability.
    3. The profitability going down has an effect on the shareholders. Their earnings become uncertain.
    4. With the decline in goodwill of the company, share prices decline. As a result shares cannot be marketed in capital market.
2. **On Company-**
    1. Because of low profitability, reputation of company is lowered.
    2. The company’s shares cannot be easily marketed.
    3. 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.

    4. In order to retain the company's image, the company indulges in malpractices like manipulation of accounts to show high earnings.
    5. The company cuts down it's expenditure on maintainance, replacement of assets, adequate depreciation, etc.
3. **On Public-** An overcapitalized company has got many adverse effects on the public:
    1. In order to cover up their earning capacity, the management indulges in tactics like increase in prices or decrease in quality.
    2. Return on capital employed is low. This gives an impression to the public that their financial resources are not utilized properly.
    3. Low earnings of the company affects the credibility of the company as the company is not able to pay it's creditors on time.
    4. 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.**

Effects of Under Capitalization

1. **On Shareholders**
    1. Company's profitability increases. As a result, rate of earnings go up.
    2. Market value of share rises.
    3. Financial reputation also increases.
    4. Shareholders can expect a high dividend.
2. **On company**
    1. With greater earnings, reputation becomes strong.
    2. Higher rate of earnings attract competition in market.
    3. Demand of workers may rise because of high profits.
    4. The high profitability situation affects consumer interest as they think that the company is overcharging on products.
3. **On Society**
    1. With high earnings, high profitability, high market price of shares, there can be unhealthy speculation in stock market.
    2. 'Restlessness in general public is developed as they link high profits with high prices of product.
    3. Secret reserves are maintained by the company which can result in paying lower taxes to government.
    4. The general public inculcates high expectations of these companies as these companies can import innovations, high technology and thereby best quality of product.

Theories of Capitalization:

We have seen that capitalization refers to the determination of the value through which a firm is to be capitalized. In the context of capitalization there are two popular theories: Cost Theory and Earning Theory.

i. Cost Theory:

This theory is focused on the cost of acquiring assets. The total value of capitalization under the Cost Theory is the sum total of costs of acquiring both fixed and current assets. Under this theory the costs incurred for issue of shares and other securities are also included in capitalization.

Hence capitalization is the sum of land and building, plant and machinery and other fixed assets, stock of raw materials, debtors and other current assets and preliminary expenses. This theory is best used by a new firm as it helps to find the total amount of capital needed for establishing the business.

The theory suffers from the following limitations:

a) It highlights only the cost aspect but not the capacity of the assets;

b) It remains silent about time when the asset becomes obsolete; and

c) For a firm having fluctuating earnings, the theory loses its importance.

ii. Earning Theory:

Under this theory the earning capacity of the business is considered as the basis of capitalization. According to this theory the capitalized value of earning of the firm is the amount of capitalization. Industry's representative rate of return is taken as the rate of capitalization.

The value of capitalization is calculated thus:
Capitalization = Average Annual Future Earnings / Capitalization Rate x 100

This theory also suffers from the following limitations:
a) Estimation of future earning for a new company is very difficult;

b) Rate taken for capitalization may not be proper representative of the firm; and

c) Mistake committed at the time of estimating the earnings will directly influence the amount of capitalization.

Numerical Example:-

A company has a capital of Rs 10,00,000. The value of its assets amounts to Rs 10,00,000. Its earnings amount to Rs 90,000. The rate of return in the industry is 10%. Does it show optimal capitalisation?

Solution:-

As per the cost theory, capitalisation is optimal insofar as the capital is equal to the cost of the assets.

But as per the earning theory, its earnings based on industry norms should be equal to: Rs 10,00,000 × 0.10 = Rs 1,00,000

Since its actual earnings < the required earnings, the company stands over-capitalised.