

BASICS OF FINANCE

MODULE-8

× CAPITALISATION

- ✘ MEANING AND DEFINITION OF CAPITALISATION
- ✘ TYPES OF CAPITALISATION
- ✘ CAUSES OF IT
- ✘ REMEDIES OF IT

✘ Capitalisation =

✘ Share capital short term borrowings+ long term borrowing+reservers+Debenture capital

DEFINATION

- ✘ According to Gerstenberg, “Capitalisation comprises of a company’s ownership capital which includes capital stock and surplus in whatever form it may appear and borrowed capital which consists of bonds or similar evidences of long-term debt.”
- ✘ According to Guthman and Dougall, “Capitalisation is the sum of the par value of stocks and bonds outstanding.”

MEANING AND DEFINATION OF CAPITALISATION

- ✘ Capital is important concept to every business organisation
- ✘ Broadly the term 'Capitalisation' refers to the process of determining the plan of financing.
- ✘ It includes not the quantity of finance required for a company but also the quality of financing.
- ✘ The term “**Capitalisation**” has been derived from the word capital and in common practice it refers to the total amount of capital employed in a business.

TYPES OF CAPITALISATION

- ✘ Overcapitalisation
- ✘ Undercapitalisation



OVERCAPITALISATION

- ✘ In simple term it means the capital is more than the actual requirement
- ✘ Overcapitalization refers to a situation where the company has raised capital beyond the specific limit which is unhealthy in nature for the company.
- ✘ market value of the company is less than the capitalized value of the company.

BASICS OF FINANCE

MODULE-8

OVERCAPITALISATION CAUSES EFFECTS AND REMEDIES

CAUSES OF OVERCAPITALISATION

(i) Acquisition of Assets at Higher Prices:

(ii) Higher Promotional Expenses:

(iii) Underutilisation:

(iv) Insufficient Provision for Depreciation:

(v) Liberal Dividend Policy:

(vi) Inefficient Management:

EFFECTS OF OVER-CAPITALISATION ON SHAREHOLDERS:

On shareholders :

- ✘ (i) Over-capitalisation results in reduced earnings for the company **the shareholders will get lesser dividend.**
- ✘ (ii) **Market value of shares** will go down because of lower profitability.
- ✘ (iii) There may be **no certainty of income to the shareholders in the future.**
- ✘ (iv) **The reputation of the company will go down.** Because of this, the shares of the company may not be easily marketable.
- ✘ (v) In case **of reorganisation**, the face value of the equity share might be brought down.

ON SOCIETY

- × **Loss to Consumers**-Increased prices and reduction in quality
- × **Loss to workers**-no jobs problem of unemployment
- × **Gambling of Shares**- scope of civil effects
- × **Recession**-increased losses, unemployment, decline in wage rate

ON COMPANY



REMEDIES TO CONTROL OVERCAPITALISATION

- ✘ Efficient Management
- ✘ Redemption of shares
- ✘ Refunded of depts
- ✘ Reorganisation of equity share capital
- ✘ Reduction in interest on debentures and loan

BASICS OF FINANCE

MODULE-8

UNDERCAPITALISATION CAUSES EFFECTS AND REMEDIES

UNDERCAPITALISATION

Undercapitalization

- Under-capitalization is just the reverse of over-capitalization. A company is considered to be under-capitalized when its actual capitalization is lower than its proper capitalization as warranted by its earning capacity.

CAUSES OF UNDERCAPITALISATION

- × Efficient management:
- × Underestimation of capital requirement
- × Underestimation of rate of earnings
- × Overestimation of rate of return at time of promotion
- × Large Secret reserves-
- × Conservative dividend policy:
- × Difficulty in raising capital:
- × Depression:
- × Purchase of assets at lower rate
- × Less Promotional cost
- × Earning in new economic and business environment

- ✘ **Efficient Management:-**The management of a company may be highly efficient. It may issue the minimum share capital and may meet the additional financial requirements through borrowings at lower rates of interest.
- ✘ **Creation of Secret Reserves:**
- ✘ A company may have large secret reserves due to which its profitability is higher.
- ✘ **Acquisition of Assets during Recession:**
- ✘ Assets might have been acquired at low costs during necessary conditions in the market. And now higher incomes are being earned by their use.

EFFECTS ON SHAREHOLDERS

- ✘ The profitability of the company may be very high. As a result, the rate of earnings per share will go up.
- ✘ The value of its equity share in the market will go up.
- ✘ The financial reputation of the company will increase in the market.
- ✘ The shareholders can expect higher dividends regularly.

COMPANY

- ✘ Because of higher profitability, the market value of company's shares would go up. This would also increase the reputation of the company.
- ✘ The management may be tempted to build up secret reserves.
- ✘ Higher rate of earnings will attract competition in the market.
- ✘ The workers of the company may be tempted to demand higher wages, bonus and other benefits.
- ✘ The government may increase tax rates on companies earning exceptional profits.

EFFECTS ON SOCIETY

- ✘ Under-capitalisation may lead to higher profits and higher prices of shares on the stock exchange. This may encourage unhealthy speculation in its shares.
- ✘ The consumers feel exploited. They link higher profits with higher prices of the products.
- ✘ The management of the company may build up secret reserves and pay lower taxes to the Government.

REMEDIES-

- ✘ Under-capitalisation may be remedied by increasing the **par value and/or number of equity shares** by revising upward the value of assets.
- ✘ Management may capitalise the earnings by issuing bonus shares to the equity shareholders. This will also reduce the rate of earnings per share without reducing the total earnings of the company.
- ✘ Where under-capitalisation is due to insufficiency of capital, more shares and debentures may be issued to the public.