Capitalization and It's Implication

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Abstract: **Capital formation and its effective utilisation is a main stream activity in any business. Managers of various specialisations and at different levels of organisation would be expected to contribute to efficient use of capital funds. The following article makes an attempt to present the basic features of capital mobilisation and a balanced use of such capital for the day to day business. The principles of capitalisation as established by various authors and researches are reviewed.**

Keywords: **Capitalisation, sources, Components of capital structure, over capitalisation, undercapitalisation, impact on business, tools for utilising capital, efficient of capital measures.**

I. INTRODUCTION

Capital is like the blood stream of a business to decide on its success or otherwise. Therefore, a good understanding of all aspects of capital accumulation and utilisation of capital becomes an essential strength in running any types of business. Management Knowledge theory and practice have elaborately dealt with this aspect in number of ways. The word capital refers to the promoter's investment and other forms of legally valid accumulated funds. Amount of capital thus invested gives a measure of the size of the business and its nature in terms of people, technology, market and profitability of the business. In business literature it is referred as the sum total of the par value of all shares.

In business it refers to the total par value of all securities at a given time plus valuation of all securities at a given time plus valuation of all other long term obligations. The formation of capital requires a sound financial planning approach to fulfil the various norms establish for capital formation and utilisation. The amount of capital can neither exceed the requirements (i.e. over capitalisation) nor fall short of the amount required (under capitalization to run the business profitability. over capitalisation will result in payment of higher interest whereas under capitalisation will result in poor business turn over and profitability. In either case the management will be loser for not bringing about a proper balance in these two categories of capitalisation.

Thus sound financial planning will enable the management to decide the optimum amount of capital requires running the business successfully.

II. CAPITAL FORMATION

Corporate capital comprises of various components depending upon the nature of a capital fund.

1. Owners investment
2. Borrowed funds (long term short term uses)
3. Issue of debenture

III. THEORETICAL GUIDELINES

There are two under these categories first; earning theory its states that the strength of the company in utilising is capital funds gets reflected in its earning capacity. This refers to the estimated value of the earnings. This estimated earnings should be comparable with the actually earnings. The estimated earnings should also be comparable with the earnings of other companies engaging in similar activities. The management should then apply this comparative rate of earnings with their own estimated earnings. These compressions should lead to deciding the capital requirements.

In already established company annual net earnings and capitalisation are compared with previous year's performance to make necessary adjustment in capital formation.

Another important comparison could be capitalisation rate and cost of capital that reflect on the return from invested capital that would adequately compensate the investors interest from a fair rate of return.

Cost Theory

The second theory focus as on the aggregate cost of fixed assets such as land, building, plant and machinery etc. invested in establishing and promoting the business and the amount of regular work capital. In the case of new business this capital amount gives a clear picture of the amount of capital required to run the business. This theory is helpful to locate the extent to which these kinds of assets are successfully deployed to earn a fair rate of profit.

IV. IMPACT OF OVER OR UNDER CAPITALISATION ON THE BUSINESS

A business is said to be over capitalised under the following conditions.

When the outstanding par values of stock and bonds exceeded the value of fixed assets the company said to be over capitalisation. (Or)

A company will be said to be over capitalised when its earnings are not sufficient to yield fair return on the amount of stocks and debentures that have been issued. Also

when the amount of outstanding security exceeds the current value of the assets. (or)

When a company is not able to consistently earn the prevailing rate of return and therefore, paying only a lower rate of dividends for a couple of years. It would mean that the company is over capitalised.

Thus it may be observed over capitalisation develops as a result of running the business under adverse conditions. Over capitalisation is to be differentiated from excess of capital.

Business practices such as floating of excess capital purchasing asset at inflated prices, high promotional expenses resorting to borrowing at higher interest rate failing to provide for depreciation high rates of taxation being liberal in dividend policy estimating feature earnings wrongly and a low level of production can be identified as the reason for over capitalisation. These functions have to be perfected while running the business to avoid over capitalisation.

V. UNDER CAPITALISATION

Under capitalisation refers to a state of business condition where the value of the assets is much more than it appears in the books of the company. This may be observed to be a reverse a set of conditions of over capitalisation, under capitalisation can be linked with effective utilisation of investment and a liberal policy of paying high rate of dividend. Thus the rate of profits earned by the company on the total capital invested is exceptionally high. The company enjoys a relatively better reputation when compared to others in the industry.

VI. SUGGESTION FOR MANAGEMENT ACTION TO PREVENT THE ILLS OF BOTH OVER CAPITALISATION AND UNDER CAPITALISATION

The foregoing analysis focuses on the fact that both over capitalisation and under capitalisation are harmful to the financial interest of a company. Therefore the management should resort to excessive of effective control over the utilisation of capital funds.

An imbalance in maintaining the capital utilisation process that results either in over capitalisation or under capitalisation calls for an attention of management to prevent the disadvantages to the company. These disadvantages may be listed as follows.

1. *Loss of good*

   Shareholder tends to lose confidence in the company. Because of large variation in the rate of dividends paid as compared to other well run companies. This leads to damage the good will of the company among shareholders.

2. *Difficultly in capital acquisition.*

   The set back experience by the company in losing the good will of the investors makes it difficult in mobilising further capital needed by the company.

3. *Window dressing of accounts*

Poor financial reputation is suffered by the company when attempts by the management to adopt objectionable devices like window dressing of accounts to cover up lack of profits and ability to pay higher rate of dividend the accounts are suitably manipulated.

The disturbance caused by capital deficiency encourages management to take recourse to obtaining debts at high interest rates that only aggravate the crises.

4. *Reduced efficiency*

The above adverse condition of deficient capital and decreased earnings funds repairs and renewals are postponed. It leads to a fall of efficiency in the operations of the company.

5. *Liquidation of the company*

Under more severe financial crises the company may pushed to a state of total failure it finds it difficult to settle interest for borrowed capital the conditions may then demand liquidation unless immediate steps are taken to reorganise the share capital structure.

6. *Loss of market*

Inability to pay the rates of dividends comparable to other company in the industry may lead to a compelling situations of losing its customer to competitors thus a company suffers a loss of market share.

VII. IMPACT OF SHARE HOLDERS

Share holders as investors to the company's capital are to be considered as real owners. Capital imbalance efficiencies became the concern of the share holder.

1. Low rate of dividend

Shareholders are disappointed over the uncertain and irregular rate of return.

2. Fall in the market value of shares

Shares of over capitalised company are generally valued low. Therefore the share holders feel that force is a fall in the rate of return of their investment because of the depreciation of their investment. This makes it difficult for the shareholder to sell their share at a reasonable rate if they want to.

3. Loss on re-organisation:

Among the various measures to overcome the ills of over capitalisation total reorganisation of the company can be

one. But the cost of reorganisation will fall heavily on shareholders interest. This is so because reorganisation calls for reduction of capital and writing off past loses. The resulting loss of par value of share will fall on the shareholders.

Instead if the company is going for liquidation the shareholder has to be satisfied inthe possible reduction of the original investment.

4. Reduced value of the collateral security of their share

Shareholder looses the potential of using their shapes for collateral purpose when they want to use the value of this share for borrowing from other financial institutions using their shares as collateral security.

5. Speculative gambling

The prize of share over capitalised companies are generally unstable it leads to speculative gambling and the real investors suffer an account of these manipulation.

VIII. IMPACT ON SOCIETY

As already discussed over capitalisation results in business inefficiencies that too causes certain negative impact on the society. This may be broadly summed up as follows.

Our capitalisation company practice wage cut and reduction of welfare facilities to workers that in turn disappoint workers resulting in poor industrial relation workers tend to lose their interest on the job that may cause poor product quality and lack of job security.

In such a panic stricken condition, management action and Causes of misutilization of society recourses may lose their competitive position in the market.

The scope for gambling in shares of over capitalised companies develops into a undesirable social phenomenon. In essence the position of an over Capitalisation Company adversely suffers in the society.

XI. DISADVANTAGE OF UNDER CAPITALISATION

Under capitalisation share values enjoys a higher market rate and therefore limits the marketability of these shares. A condition of high rate of earnings also attracts more competitions leading to severe competition.

Under capitalisation may lead to labour unrest because of a higher demand on wages and other benefits due to perceived higher earnings of the company. This may cause strained industrial relations.

1. Customer dissatisfaction

Customer who became aware of higher earnings by the company may believe that they are charged higher prices for the products. Therefore they may demand a reduction in prices.

Government control may be, tightened as the earnings per share rises. Competitors may demand a lowering of prices. The company may suffer Government control under anti-trust loss.

2. Capital shortage

Under capitalized company always resorts to low capital investment and looks for outside resources for the financial needs.

X. SUGGESTED REMEDIAL ACTIONS TO BRING ABOUT BALANCE IN CAPITALISATION

Under condition of over capitalisation

1. Reduction of funded debts control must be exercised to keep the debentures and bonds.
2. To reduce commitment on payment of interest from earnings. Actions regarding company reorganisation crises of shares fixing of share prices conversion of bonds in to shares have to be properly managed.
3. Wherever possible a lower rate of interest must be negotiated with buyers of debentures and bonds.
4. Reduction of preference shares
    a. Commitment on payment of interest on preference share caring a high rate of dividend should be reduced.
5. Reduction in face value of equity shares
    a. Equity shareholders may be persuaded to accept a lowering of the share values also a number of equity share may be kept limited.
6. Re-investment of gained profits

The profits earned from the above measures must be reinvested in running the business.

XI. REMEDIAL MEASURES TO CORRECT UNDERCAPITALISATION

Undercapitalisation may be corrected by the following measures.

1. *Splitting of Shares*

Shares of lower value may be issued in place of high value shares this will be helpful to pay lower rate of dividend per share without affecting the profits of the company.

2. *Increasing par value of shares*

The assets of the company may revalue to show a higher price of shares. The existing shareholders may be allotted the higher face valued shares in exchange for old shares. This will help to reduce the rate of earnings per share without affecting the dividends per share.

3. *Issue of bonus shares*

The most common method to remedy under capitalisation in to the issue bonus shares. This method will increase the

capitalisation and number of shares. Dividend payment and rate of earnings will be correspondingly reduced.

4. *Fresh issue of shares*

The company may choose to issue fresh equity share to replace its debts this measure will increase the number shares but the reduced the rate of dividend. Total earnings of the company will not be affected.

Reducing for under - capitalisation - Summary

1. To split up the shares of the enterprise
2. To issue bonus shares
3. To increase the par value of shares/stock
4. To declare dividend payable in stock holders, if large surplus is available.

XII. SOME OF THE MEASURES TO CORRECT THE SITUATION CAUSED BY OVERCAPITALISATION ARE

1. Purchased in earnings.
2. Plough back earnings.
3. Reduction of the debt.
4. Reduction of interest rate on bonds.
5. Redemption of referrer stock if it carries a wish dividend.
6. Reduction in par value of shares and
7. Reduction in the number of enquiring shares of common stock.

XIII. CAUSES OF UNDER CAPITALISATION - SUMMARY

1. The causes of under capitalisation are:
2. Under capitalisation of initial head rate of earnings.
3. Utilization of high efficiency for exploiting every prohibility available.
4. Using long rate of capitalisation.
5. Under estimation of required funds.
6. Retaking profits because of conservative dividend policy followed by the enterprise.
7. Setting up of an enterprise in cessionary conditions. After the recession period is over enterprise start earnings profits at an unusually high rate.
8. Because of excessive earnings, enterprises are exposed to a heavy incidents burden of taxation.

XIV. CONCLUSION

An understanding of capitalisation is essential for running a business. Therefore going paragraph describe delineate the factors that are essential in understanding capitalisation and use that knowledge for efficiently running a business. Managers irrespective of specialisation would be expected to posses and practice a prudent knowledge of company capital its mobilisation and utilisation this articles aims at helping managers to deal with capital utilisation in the best.

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