# CAPITALIZATION

Capitalization is one of the most important parts of financial decision, which is related to the total amount of capital employed in the business concern.

Understanding the concept of capitalization leads to solve many problems in the field of financial management. Because there is a confusion among the capital, capitalization and capital structure.

The term capital refers to the total investment of the company in terms of money, and assets. It is also called as total wealth of the company. When the company is going to invest large amount of finance into the business, it is called as capital. Capital is the initial and integral part of new and existing business concern. The capital requirements of the business concern may be classified into two categories: (a) Fixed capital (b) Working capital.

## Meaning of Capitalization

Capitalization refers to the process of determining the quantum of funds that a firm needs to run its business. Capitalization is only the par value of share capital and debenture and it does not include reserve and surplus.

According to Guthman and Dougall, "capitalization is the sum of the par value of stocks and bonds outstanding".

"Capitalization is the balance sheet value of stocks and bonds outstands". — Bonneville and Dewey

According to Arhur. S. Dewing, "capitalization is the sum total of the par value of all shares".

## TYPES OF CAPITALIZATION

Capitalization may be classified into the following three important types based on its nature:

• Over Capitalization

• Under Capitalization

• Water Capitalization

### Over Capitalization

Over capitalization refers to the company which possesses an excess of capital in relation to its activity level and requirements. In simple means, over capitalization is more capital than actually required and the funds are not properly used.

According to Bonneville, Dewey and Kelly, over capitalization means, "when a business is unable to earn fair rate on its outstanding securities".

Example A company is earning a sum of Rs. 50,000 and the rate of return expected is 10%. This company will be said to be properly capitalized. Suppose the capital investment of the company is Rs. 60,000, it will be over capitalization to the extent of Rs. 1,00,000. The new rate of earning would be: 50,000/60,000×100=8.33% When the company has over capitalization, the rate of earnings will be reduced from 10% to 8.33%.

### Causes of Over Capitalization

Over capitalization arise due to the following important causes:

• Over issue of capital by the company.

• Borrowing large amount of capital at a higher rate of interest.

• Providing inadequate depreciation to the fixed assets.

• Excessive payment for acquisition of goodwill.

• High rate of taxation.

• Under estimation of capitalization rate.

## Effects of Over Capitalization

Over capitalization leads to the following important effects:

• Reduce the rate of earning capacity of the shares.

• Difficulties in obtaining necessary capital to the business concern.

• It leads to fall in the market price of the shares.

• It creates problems on re-organization.

• It leads under or misutilization of available resources.

## Remedies for Over Capitalization

Over capitalization can be reduced with the help of effective management and systematic design of the capital structure. The following are the major steps to reduce over capitalization.

• Efficient management can reduce over capitalization.

• Redemption of preference share capital which consists of high rate of dividend.

• Reorganization of equity share capital.

• Reduction of debt capital.

## Under Capitalization

Under capitalization is the opposite concept of over capitalization and it will occur when the company's actual capitalization is lower than the capitalization as warranted by its earning capacity. Under capitalization is not the so called inadequate capital.

Under capitalization can be defined by Gerstenberg, “a corporation may be undercapitalized when the rate of profit is exceptionally high in the same industry”.

Hoagland defined under capitalization as “an excess of true assets value over the aggregate of stocks and bonds outstanding”.

### Causes of Under Capitalization

Under capitalization arises due to the following important causes:

• Under estimation of capital requirements.

• Under estimation of initial and future earnings.

• Maintaining high standards of efficiency.

• Conservative dividend policy.

• Desire of control and trading on equity.

### Effects of Under Capitalization

Under Capitalization leads certain effects in the company and its shareholders.

• It leads to manipulate the market value of shares.

• It increases the marketability of the shares.

• It may lead to more government control and higher taxation.

• Consumers feel that they are exploited by the company.

• It leads to high competition.

## Remedies of Under Capitalization

Under Capitalization may be corrected by taking the following remedial measures:

1. Under capitalization can be compensated with the help of fresh issue of shares.

2. Increasing the par value of share may help to reduce under capitalization.

3. Under capitalization may be corrected by the issue of bonus shares to the existing shareholders.

4. Reducing the dividend per share by way of splitting up of shares.

## Watered Capitalization

If the stock or capital of the company is not mentioned by assets of equivalent value, it is called as watered stock. In simple words, watered capital means that the realizable value of assets of the company is less than its book value.

According to Hoagland’s definition, “A stock is said to be watered when its true value is less than its book value.”

## Causes of Watered Capital

Generally watered capital arises at the time of incorporation of a company but it also arises during the life time of the business. The following are the main causes of watered capital:

1. Acquiring the assets of the company at high price.

2. Adopting ineffective depreciation policy.

3. Worthless intangible assets are purchased at higher price.