Exploring Over Capitalization, Under Capitalization, and Watered Capital

Ravi Kiran Pulugam

Tax Associate (U.S. Taxation), IBSN Tax Solutions,

US Individual Tax Consultant, India

ABSTRACT

Financial planning and decision-making play a critical role in the field of financial management, covering key areas such as capitalization, financial structure, leverage, and forecasting. Capital refers to the total investment of a company in the form of money and assets, serving as the foundation of both new and existing business operations. Capitalization, in this context, denotes the process of determining the total amount of funds required for running a business efficiently. An imbalance in capitalization may lead to over capitalization, under capitalization, or watered capitalization, each of which affects profitability, efficiency, and shareholder value in distinct ways. This paper provides an overview of the types of capitalization, their causes, effects, and possible remedies, highlighting their importance in ensuring sound financial management.

Index Terms: capitalization, financial planning, capital, financial management

I. INTRODUCTION

Financial planning includes the following important parts:

- Estimating the amount of capital to be raised.
- Determining the form and proportionate amount of securities.
- Formulating policies to manage the financial plan.

MEANING OF CAPITAL

The capital requirements of the business concern may be classified into two categories:

(a) Fixed capital

(b) Working capital.

Fixed Capital

Fixed capital is the capital, which is needed for meeting the permanent or long-term purpose of the business concern. Fixed capital is required mainly for the purpose of meeting capital expenditure of the business concern and it is used over a long period. It is the amount invested in various fixed or permanent assets, which are necessary for a business concern.

Definition of Fixed Capital

According to the definition of **Hoagland,** "Fixed capital is comparatively easily defined to include land, building, machinery and other assets having a relatively permanent existence".

Character of Fixed Capital

- Fixed capital is used to acquire the fixed assets of the business concern.
- Fixed capital meets the capital expenditure of the business concern.
- Fixed capital normally consists of long period.
- Fixed capital expenditure is of nonrecurring nature.
- Fixed capital can be raised only with the help of long-term sources of finance.

Working Capital

Working capital is the capital which is needed to meet the day-to-day transaction of the business concern. It may cross working capital and net working capital. Normally working capital consists of various compositions of current assets such as inventories, bills, receivable, debtors, cash, and bank balance and prepaid expenses.

According to the definition of **Bonneville,** "any acquisition of funds which increases the current assets increase the Working Capital also for they are one and the same".

Working capital is needed to meet the following purpose:

- Purchase of raw material
- Payment of wages to workers
- Payment of day-to-day expenses
- Maintenance expenditure etc.

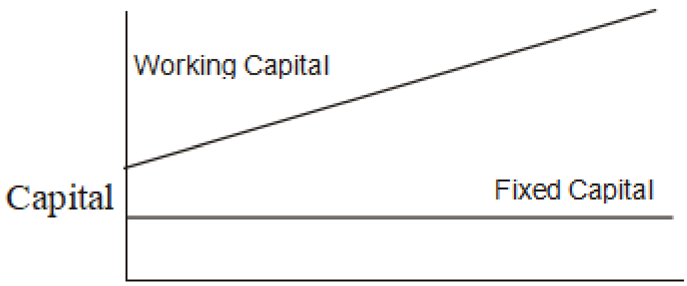

Figure 1: Position of Capital

II. 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.

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.

Definition of Capitalization

Capitalization can be defined by the various financial management experts. Some of the definitions are mentioned below:

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".

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

III. 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:

$50,000/60,000 \times 100 = 8.33\%$

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 misutilisation 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 under capitalized 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.

IV. CONCLUSION

Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalization. It is the mix of different sources of long-term sources such as equity shares, preference shares, debentures, long-term loans and retained earnings. The term capital structure refers to the relationship between the various long-term source financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm.

REFERENCES

1. Prasanna Chandra: Investment Analysis and Portfolio Management; McGraw Hill Education (India) Pvt. Ltd., New Delhi.

2. I M Pandey: Financial Management; Vikas Publication House Ltd., New Delhi.

3. Eugene F Brigham & Michael C Ehrhardt: Financial Management– Theory and Practice; Cengage Learning (India) Pvt. Ltd., New Delhi.

4. J Van Horne & John M. Wachowicz: Fundamentals of Financial Management; Pearson Education Ltd. New Delhi.