Over-capitalisation is not desirable in the long run interest of the shareholders and the company. It leads to lower rate of dividend, reduction in the market value of shares and difficulty in raising more funds. Hence, there is need to rectify such situation as quickly as possible by reducing debt, efficient utilisation of assets, and by following a conservative dividend policy.

Effects of Over-capitalisation	**Remedies of Over-capitalisation**
• Lower rate of dividend	• Debts may be redeemed
• Reduction in market value of share	• Efficient utilisation of resources
• Difficulty in raising additonal funds.	• Conservative dividend policy

17.3.2 UNDER-CAPITALISATION

Under-capitalisation is just the reverse of over-capitalisation. In other words, a company is said to be under-capitalised if its capital employed is less than its proper capitalisation i.e., the amount of capital invested is not justified by its annual earnings. In the earlier case, for example, if the company's actual capital employed is Rs. 16,00,000 it shall be treated as under-capitalised as it is less than Rs. 20,00,000, the proper capitalisation. Alternatively, if a company's actual rate of earnings is more than the normal rate of return, it is treated as a case of under-capitalisation. This does not imply that the company suffers from inadequacy of capital.

In fact, such a situation may be the result of underestimation of expected earnings while deciding on the amount of capital to be raised or using low capitalisation rate for the purpose or by following a conservative dividend policy. Of course, improvement in earnings can also be the result of cost reduction exercise or high efficiency. Thus, under-capitalisation is indicative of a sound financial position and may lead to increase in the market value of company's shares. However, it can encourage competition as high rate of return may attract new entrants in the field. The workers of the company may demand for higher wages and other benefits. When the company earns more profit, the customers may feel that they are being over-charged by the company. So, it is better to take corrective steps like capitalisation of profits (issue bonus shares) or splitting up of the shares (a share of Rs.10 may be converted into five shares of Rs. 2 each). Although under-capitlisation is considered a lesser evil than over-capitalisation (as the situation can be remedied more quickly) it is better to ensure a fair or proper capitalisation.

Effects of Under-capitalisation	**Remedies of Under-capitalisation**
• Market value of shares goes up since earning are high	• Issue of bonus shares
• Workers may demand higher wages	• Splitting up of shares
• The high rate of earnings may encourage outsiders to start similar business and thus competition is increased.	• Higher earnings attract competition which ultimately reduces earnings. So the market forces also automatically correct the situation of under-capitalisation. .

INTEXT QUESTIONS 17C

1. What is meant by the term 'Capitalisation'?

2. Correct and rewrite the following statements if found incorrect.

   (a) Under-capitalisation may lead to an increase in the price of company's equity shares in the market.

   (b) Over-capitalisation may be caused by underestimation of capitalisation rate.

   (c) Under-capitalisation refers to a situation when the actual rate of earnings is lower than the normal rate of return.

   (d) Over-capitalisation refers to a situation when the amount of capital employed in a company is more than what is justified by its earnings.

   (e) Over-capitalisation is less harmful than under-capitalisation.

3. The balance sheet of AB Ltd. as on March 31, 2008 is as follows:

Liabilities	Rs.	Assets	Rs.
Share capital		Fixed assets	1,00,000
6,000 equity shares of Rs. 10 each	60,000	Current assets	80,000
Reserves and surplus	40,000		
8% Debentures	50,000		
Currents liabilities	30,000		
	1,80,000		1,80,000

The earnings of the company from the year 2007-08 were Rs. 18,000 while the normal rate of earnings on capital employed in similar companies is 15%.

Compute (a) its proper or fair capitalisation as justified by the company's earnings, and (b) state whether it is over-capitalised or under-capitalised.

17.4 Capital Structure

The financial requirement of a firm can be met through **ownership** capital and/or **borrowed** capital. The **ownership** capital refers to the amount of capital contributed by the owners. In case of a company, it refers to the amount of funds raised by issuing shares. The main characteristic of the ownership capital is that its contributors are entitled to get dividend out of earnings after the payment of interest and taxes. Hence, the rate of return on such capital depends upon the level of profits earned, and, if there are no profits, no dividend may be paid.

Borrowed capital, on the other hand, refers to the amount of funds raised through long term loans and debentures on which its contributors are entitled to a fixed rate of interest which has to be paid at regular intervals (half-yearly or yearly) irrespective of the profits earned. There is also a commitment that the principal amount shall be repaid on maturity. However, it is still considered advantageous to finance business activities through borrowed capital because if the rate of earnings from the planned business investment is expected to be better than the rate of interest on the borrowed funds, it shall ensure higher returns on owners' funds. Let us take an example and understand this concept more clearly.

Capital Structure

	Illustration - 'A' **Total Capital Rs. 50 lakh** **(Rs. 20 lakh owners fund+** **Rs. 30 lakh borrowed fund)**	**Illustration - 'B'** **Total Capital Rs. 50 lakh** **(Rs. 50 lakh owners fund+** **no borrowed fund**
Earnings before interest and tax (EBIT)	10,00,000	10,00,000
Less : Interest @ 10% on borrowed fund	3,00,000	—
Profit/Earnings after interest but before tax	7,00,000	10,00,000
Less : Tax on profit @ 40%	2,80,000	4,00,000
Profit after tax (PAT)	4,20,000	6,00,000
Return on owners' funds $\left(\frac{\text{PAT}}{\text{Owners'funds}} \times 100\right)$	$\frac{4,20,000}{20,00,000} \times 100 = 21\%$	$\frac{6,00,000}{50,00,000} \times 100 = 12\%$

Suppose the total investment in a business is Rs. 50 lakh, to which owners contribute Rs.20 lakh and the remaining amount of Rs.30 lakh is funded through loans at 10% interest per annum. Assuming expected annual earnings before interest and tax are Rs. 10 lakh (20% on total investment) the profit after payment of interest but before tax will be Rs.7 lakh (Rs.10 lakh –Rs.3 lakh). Let us assume that the tax is payable on profits at the rate of 40%, the profit after tax will be Rs.4.20 lakh (Rs.7 lakh-