Capital

UNIT-V

U-5

In Economic view :-

Total net assests available with the business enterprise is known as capital on the other hand, in accounting terminology " capital is the difference between assests and outside Liabilities but. In general view, " capital is viewed as the amount invested in long term assests as well as in short term assests

Significance / Need for capital :

(1) To promote business :- A large variety of expenses have to be incurred on project reports preparation and fillings of various Other expenses in connection with raising of capital from the public

(2) To conduct business operation smoothly :

Firms need capital for the purpose of conducting their business operations such as research & development advertising operations, sales Promotion and rating expenses

(3) To Expand & diversity :- The firm requires lot of capital for Expansion & diversification purpose

(4) To Meet contingenicies :

The firm requires funds to meet contigencies such as a sudden fall in sales, natural calamities like fire accidents and so-- on.

(5) To pay Taxes :

The Firm has to meet its statutory commitments such as income tax & Sales tax, excise duty and so..... on.

(6) To Pay dividends & interests :-

The bussiness to make payment towards dividends and its interests to share holders & financial Institution respectively.

(7) To Replace the assests :-

The bussiness need to replace its assests like plant and machinary after a certain period of use. For this purpose the funds may need

(8) TYPES OF CAPITAL :-

Capital is can be broadly divided into 2 types :

1) Fixed capital
2) Working capital

(I) Fixed capital :- The amount invested in the acquisition and development of fixed assests is known as fixed capital. Fixed assests have permanent in nature, retained and used in the business operation and not intended for sale

Types of fixed assests :- can be divided into 3 types

(a) Tangible fixed assests :- These are physical items which can be touched and seen. Most of the common fixed assests are land, buildings, Machinery etc.

(b) Intangible fixed assests :- These do not have physical form. They can't be seen (or) touched. But these are very valuable in bussiness

Ex :- Good will, Brand names, patents trade, marks etc

(c) Financial fixed assests :- These are investments in shares foreign currency deposits, Government boards, - - - - -

Working Capital :-

"Funds invested for short term purposes such as the purchase of raw materials, payment of wages and other day to day expenses are known as "working capital".

working capital.

-> The working capital is also known as "revolving" or "circulative" short term capital.

There are two concepts of working capital.

(a) Gross working capital (b) Net working capital.

(a) Gross working capital :- refers to the capital invested in total current assets of the enterprise.

(b) Net working capital :- refers presents the excess of current assets over current liabilities.

Net working capital = current assets - current liabilities.

Components of working capital :-

current assets :- Includes cash in hand, cash at bank, Bills receivables, sundry debtors, short term loans and advances, inventories, prepaid expenses and accured incomes.

current liabilities :- Bills payable, sundry creditors, accounts payable, outstanding expenses, Dividend payable, Bank over draft and provision for taxation etc.

Factors determining the working capital requirements :-

1. Nature of business :- The working capital requirements

of a firm basically depend upon the nature of its business. public utility under takings like electricity & railways need very limited working capital because their sales are on cash. on the other hand, trading firms requirem more investment as a working capital.

2. Size of business :- The working capital requirements of a concern are directly influenced by the size of its business which may be measured interms of scale of operations. Greater the size of a business unit. Generally, larger will be the requirements of working capital.

3. Production policy :- If the demand for a given product in subject to wide fluctuations due to seasonal variations the requirement of working capital in such cases depend upon the production. If the Policy is to keep the production steady by accumulating inventories it will require higher working capital.

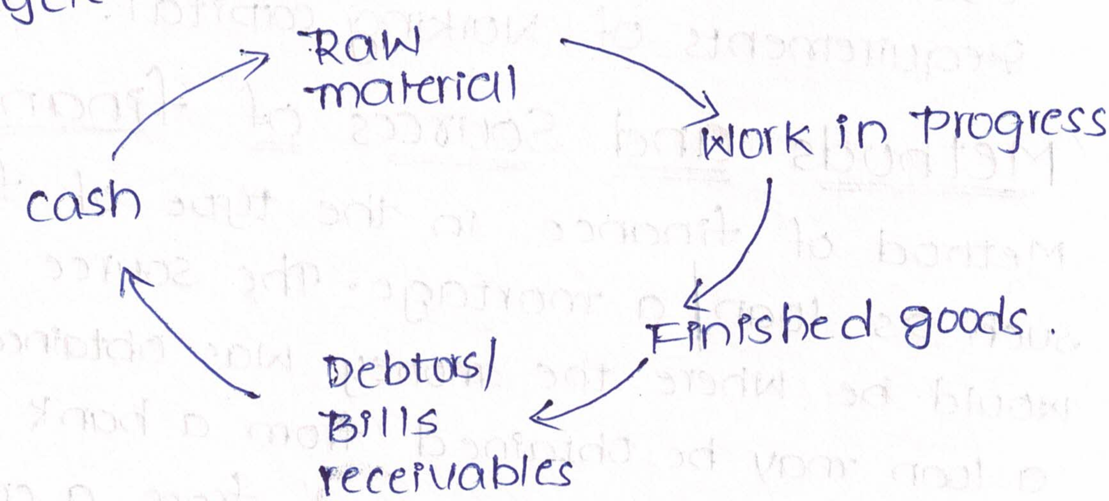
4. Manufacturing Process / Length of production cycle
The requirement of working capital will be direct relationship length of manufacturing process. Longer the process period of manufacture larger is the amount of working capital required and vice versa.

5. Seasonal Variations :- If the raw material availability is seasonal, they have to be brought in bulk during the season to ensure an unenterupted material for the production.

Generally, during the busy season, a firm requires larger working capital then in the slack season.

6. Credit Policy :- It deals with debtors & creditors. Purchases it requirements on the credit requires lesser amount of working capital compared to the firm which buys on cash.

7. Working capital cycle :- In manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realisation of cash from the sale of finished products. The cycle involves purchase of R.M and stores, its conversion into stocks of finished goods through W-I-Progress with positive increement of labour & service costs, conversion of finished stocks into sales, debtors and receivables & ultimately realisation of cash. This cycle continues again from cash to purchase of R.M & so on. In general, the longer the operating cycle the larger the requirement of working capital. The cycle is shown in the following figure.



~~8. Business scale:~~

8. Business cycle :-

Refers to alternate expansion and contraction in general business activity. In a period of boom that is when the business is prosperous, there is a need for larger amount of working capital due to increase in sales and vice-versa.

9. Rate of growth of business :- The working capital requirements of a concern increase with the growth & expansion of its business activities.

10. Dividend policy :- A firm that maintains a steady high rate of cash dividend irrespective of its generation of profits need more working capital then the firm that retain larger part of its profits and does not pay so high rate of cash dividend.

11. Other factors :- certain other factors such as operating efficiency, management ability, irregularities of supply important policy assets structure etc and also influence the requirements of working capital.

Methods and Sources of finance :-

Method of finance in the type of finance used such as loan | a mortage. The source of finance would be where the money was obtained from - a loan may be obtained from a bank while the mortgage may be obtained from a credit society.

shares held by the business in other companies and so on.

Estimation of Fixed capital :-

Generally the following aspects determine the amount of fixed capital required for a business concern.

1. **Size of the company** :- Generally the amount of fixed capital required varies with the size of the company. Relatively large firms need more fixed capital & viceversa. The scale of operations and the breadth of products of company divides this fixed capital.

2. **Nature of business** :- Generally manufacturing firms need more fixed capital, as they have to invest more in fixed assets compared to non-manufacturing firms.

3. **Nature of Technology** :- If firms go in for latest technology, naturally they have to invest more in modern technology and thus need more fixed capital and vice versa.

4. **Method of operation** :-

certain practices of business like more number of shifts, season-wise production etc. also determines the quantum of fixed capital needed for a firm.

(11) Estimation of Working capital Requirements

Generally the following are the specific factors to be considered to estimate the working capital

1. volume of output.
2. Time taken to convert.
3. Time taken to sell stocks.
4. No. of days of credit provided to debtors.
5. No. of days of credit provided to the firms by the creditors.
6. volume of cash required to meet the day-to-day expenses.
7. Time log in payment of wages & overheads.
8. price of factors of production.
9. percentage of completion of work in respect of work in progress, if any
10. Any other amounts receivable during the given period.

Methods of finance :-

The following are the common methods of finance.

* Long term finance.
* Medium term finance.
* Short term finance.

Sources of finance :- The following are the different "sources" under various "methods of finance".

1. Long term finance :- refers to that finance available for a long period say three years & above.

a) Own Capital :- refers money invested by the owners, partners / promoters in permanent and will stay with the business throughout the life of the business.

b) Share capital :- The capital of a company is divided into certain units. These units are called shares. The capital is raised by issue of shares is called "share capital". The share capital can be of two types. Those are "preference share capital" and "Equity share capital".

~~Preference share capital~~ :-

Preference shares :- shares having priority as to the payment of dividend at fixed rate and return of capital are termed as "preference shares".

Equity shares :- The shares which is not entitled to fix dividend and return of capital on priority basis is termed as "Equity shares".

c) Retained Profits :- These are the profits remaining after all the claims. It will useful at the time of expanding the business operations.

d) Long-term loans :- These are specialised financial institutions offering long-term loans, provided, the business proposal is feasible.

Ex :- IDBI.

e) Debentures :- are the loans taken by the company. It is a certificate issued by the company under its common seal acknowledging the receipt of loan.

II. Medium-term finance :-

Refers to such sources of finance where the payment is normally over one year & less than three years. The sources are as follows

(a) Bank loans :- are extended at a fixed rate of interest. These are secured loans.

(b) Hire-purchase :- The possession of the asset can be taken by making a down payment of a part of the price & the balance will be repaid with a fixed rate of interest in agreed number of Instalments.

(c) Leasing / Renting :- Where there is a need for fixed assets, the asset need not be purchased. It can be taken on lease/rent for specified number of years.

iii. Short term finance :- The finance which is available for a period of less than one year. The following are the sources.

a) commercial paper (CP) :- CP's are issued usually in large denomination by the leading, nationally reputed, highly rated & credit worthy finance companies in the public & ~~pvt~~ private sector.

b) Trade credit :- There is a short-term credit facility extended the creditors to the debtors. Normally, it is common for the traders to buy the material from supliers on credit basis.

c) Bank overdraft :- refers the customer can draw more than what he has in his savings/ current account subject to the maximum limit.

d) Advances from customers :- refers collecting full/part of the order amount from the customers in advance. such advances are useful to meet the working capital needs.

Definition of capitalisation :-

The term capitalisation has been derived from the word capital and has been defined in a number of ways. It can be defined interms of narrow interpretation and broad interpretation.

Def :-

According to broader sense :- " capitalisation refers not only to the amount of long-term funds but also include different type of securities issued and the relative proportion between them".

Capitalisation Equation :-

This may be expressed by the given equation below:

Total amount of capitalisation = Face value of equity shares + Face value of Preference share + Face value of debentures and bonds + long term Loans + surplus not meant for distribution.

Types of capitalisation :-

There are 2 types of capitalisation.

1. over capitalisation
2. Under capitalisation.

1. Over capitalisation :- The term over-capitalisation refers to the earnings of the company inadequate to make its securities setlat per value. In other words, over capitalisation means more capital than actually required.

Definition :- According to Beacham (1969) " over - capitalisation refers to " when securities in the company are issued in excess of its capitalised earning power".

Causes of over - capitalisation :-

The following are the Main causes of over capitalisati

1. Over issue of capital.
2. Acquiring assets at high price.
3. Formation during inflation.
4. shortage of capital.
5. High promotional expenses.
6. Defective depreciation policy.
7. Liberal dividend policy.
8. Taxation policy.

Remedies for over-capitalisation :-

To correct the effect on over- capitalisation, the following measures can be adopted.

1. Increase the earning capacity of a firm.
2. Redemption of preference share.
3. plough back earning.
4. Reduction of funded debts.
5. Re-organisation of equity share capital.

Under- capitalisation :-

Definition :- According to Bonneville (1991), defined the term under-capitalisation as " It is not an economic problem but a problem in adjusting the capital structure".

It is observed from the definition that under capitalisation is an index of effective and proper utilisation of funds employed in the enterprise.

Causes of under-capitalisation:-

The causes of under capitalisation are the following

1. under estimation of earnings.
2. Maintaining high standards of efficiency.
3. under estimation of capital needs.
4. Retained earnings.
5. using low capitalisation rate.
6. Large secret reserve.
7. Defletionary conditions.
8. High rate of taxation.

Remedies for under-capitalisation:-

The correct conditions of under capitalisation, the following measures maybe adopted.

1. If under-capitalisation is due to inadequate capital then it can be corrected by the issue of more shares and debentures to the public.
2. If the company has adequate surplus in hand, the whole or part of it can be capitalised by issue of bonus shares.
3. The most widely used & effective remedy for under-capitalisation is by increasing in the Par value of the company's share.
4. under capitalisation may be corrected by spliting up the stock into a large no. of shares & reducing the value of each share in accordance with the rate of

split up. This will reduce the rate of earnings per share of a company. At the same time, it will not affect the total capitalisation because only the par value of the stock is reduced.