

CHAPTER 18

CAPITAL

Objective

At the end of this chapter, students should be able to explain the meaning of capital from the point of view of the accountant, the economist and the layman; list and explain the various types of capital; explain and calculate the working capital in a given problem and state the importance of working capital.

18.1 Introduction

In chapter six of Book 1, capital as a factor of production was discussed. In this chapter, we are going to examine the meaning of capital to the economists, accountants and laymen. It is important to emphasize from the outset that, there is no sharp distinction between the interpretations of both the accountants and the economists about the concept of capital. However, the understanding of the layman about capital is not as comprehensive and academic as those of the economists and the accountants. The areas of difference between the two is in terms of classifications.

18.2 Meaning of Capital by Economists, Accountants and the Layman

- (i) Both the economists and the accountants consider capital as man made productive assets or resources which help in the production of further wealth.
- (ii) Both believe that it is wrong to regard capital as solely money or cash. They both believe that in addition to money or cash, capital includes all forms of land and buildings, machinery and office equipment, vehicles and raw materials and all other things used in productive processes purchased with money or income.
They also share the belief that capital formation takes "time", needs "waiting", and that capital results from the sacrifice of past labour, equipment and time; and that it is the savings from our past and present income.
- (iii) From the point of view of the layman, capital is *only money*. For instance, when a sole-trader wishes to start a business and he talks of capital, he means cash or money. Even in the instances of raising loan from friends, banks or shareholders (in the case of a private limited company) the layman's concept of capital is strictly cash/money. In other words, the layman's concept of capital does not include other assets and resources such as land, machinery, equipment, vehicles, raw materials etc. that are acceptable as capital to both accountants and economists. However, it is important to point out that this misconception arises from the fact that money or cash is the only means of exchange, that is, the only claim on capital. In a layman's view, therefore,

money can be regarded as capital, only when it is used to gain command over goods and services e.g. to purchase materials and employ labour.

- (iv) In Economics and Accountancy, it is normal to accept that capital desires rewards like other factors of production where wages, salaries, fees and even rent are paid to labour (as factor of production) and rent to land. Hence, in both disciplines, it is usual to accept payment of interests or dividends as rewards of loan capital or share capital respectively.
- (v) Both the economists and the accountants have argued that, the size of economic development of any country would depend on the volume of capital available for investment.

18.3 Types of Capital

In commerce, capital is classified as stated below.

- (i) **Authorised Capital:** This is sometimes known as nominal or registered capital. It refers to the total amount of each type of share that a company wishes to have power to issue. This is usually stated in the Memorandum of Association and upon which stamp-duty is paid ad-val. The company may not necessarily issue or offer shares to the public for the full amount of the nominal or registered or authorized capital which represents the overall share capital of the company.
- (ii) **Issued Capital:** The portion of the registered capital or authorized capital or nominal capital actually issued to the public or shareholders is referred to as issued capital. For example, if the authorised capital of a company is ₦500,000.00 (five hundred thousand naira) and the company issues shares for ₦300,000.00. The issued capital is said to be ₦300,000.00.
- (iii) **Paid-up Capital:** The amount paid to the company in respect of the issued capital is known as paid-up capital. In our example above, if the amount received by the company is ₦250,000.00, the paid-up capital of the company will be ₦250,000.00.
- (iv) **Called-up Capital:** This represents that portion of unpaid nominal value of shares which the company calls upon the shareholders to pay up. The nominal value of a share need not be paid immediately it is issued. In some cases, it is paid in bits. A certain percentage (say 50%) of the nominal value may be paid on application, another percentage (say 25%) when the shares are allocated. The remaining 25% can be paid later when the company calls for it. It is known as called-up capital. The usual practice in Nigeria is that shares are paid in full on application. That is, the full value of the shares is paid by the applicant or prospective shareholder.
- (v) **Capital Owned or Ownerâ€™s Equity:** This is the capital attributed to the owner or owners of a business. In other words it is the capital contributed by the proprietor, or partners or subscribed by shareholders and retained profits or profits ploughed back into the business. It is ascertained by deducting liabilities (debt owned to outsiders) from the assets (both

current and fixed). In the balance sheet, the total capital shown is the capital owned or belonging to the business organization.

(vi) (a) **Capital Borrowed or Borrowed Capital or Loan Capital:** All these terms mean the same thing. They consist of loans made to a business enterprise. They can take the form of short-term loans or capital which are got from friends and banks. Other forms of short-term loans are discounting bills of exchange and obtaining trade credit. Long-term loans or capital can be borrowed by debentures, by mortgage or through financial homes or institutions, e.g. insurance companies or trusts or pension funds.

(b) **Capital Gearing Ratio:** The ratio between the share capital and the loan capital is known as *gearing ratio*. It is indicative of how much of the capital belongs to the owners of the business. If equity (owners' capital) is higher than the loan capital, then the enterprise is *low-gearied*; alternatively, if the loan capital is higher than equity capital, it is *high - geared*.

(vii) **Capital Employed:** This is the capital used in the business. It is arrived at by deducting debt from liabilities. This is because money owed by debtors is not put to use in the business.

(viii) **Liquid Capital:** The assets which can be converted to cash with ease are known as liquid capital. It consists of cash or near cash, i.e. cash in hand and cash in bank, bills of exchange, debtors and investments that can be turned into cash at short notice.

(ix) **Circulating Capital:** These are resources in a business that have the feature of changing forms during the production processes. Examples are cash, raw materials, finished stocks, etc. The accountants also regard this category as *current assets* - so one would see that the distinction is a matter of terminology. These resources are regarded as circulating since cash can be turned to raw materials and the latter into finished products, while the finished products can be held for cash or first to debtors and the latter pay cash later.

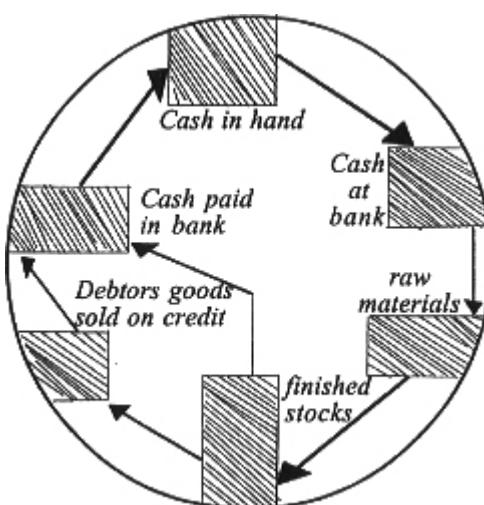


Fig. 18.1: Circulating Capital

Each item in current asset circulates through the production circle as shown above. That is unlike fixed assets each current asset items changes facet - cash to raw materials, then to finished goods, which are sold on credit or sold for cash directly into bank.

- (x) **Fixed Capital:** These are assets in the use of organisation that possess relatively long life and do not change their forms in the process of production. That is, there are durable assets used time and again in the production of further wealth. Examples are factory and office building, lands, machinery and equipment, vehicles, roads, docks, railways, aircrafts etc. The accountant also recognizes this category, but would refer to them as *fixed assets*.
- (xi) (a) **Share Capital:** This is a kind of capital raised through the sales of shares. Such shares could be ordinary share capital in which the shareholders become owners of the company or regarded as equity share capital holders. They are not creditors to the company, but owners.
- (b) **Preference Share Holders:** These shares carry a fixed dividend and mostly, unless otherwise, these shareholders are creditors since their shares carry a percentage e.g. 10% or 15% preference share holders. These are not equity shareholders and so are not owners of the business or enterprise.
- (xii) **Loan Share Capital or Debenture Capital:** This is essentially a loan to the business. The debentureâ€™s holderâ€™s are creditors and not owners of the business and therefore cannot attend or vote at ordinary shareholderâ€™s meeting.

18.4 Calculation of Working Capital

- (i) **Meaning of Working Capital:** The amount of capital that is available for the day-to-day running of a business is called the working capital. It is the excess of current assets over current liabilities.
- (ii) **Calculation of Working Capital:** Working capital is calculated from a balance sheet as at a particular date. For example:

The following is the balance sheet of PEMBIS ENTERPRISES as at 31 December 2003.

Liabilities	N	Assets	N
Share Capital	95,000	Land & Building	30,000
Creditors	200,000	Stock	110,000
Bills payable	100,000	Bill receivable	100,000
Accrued expenses	5,000	Debtors	90,000
		Cash	70,000
			370,000
	N400,000		N400,000

Calculate the current assets as follows:

	N
Stock	110,000

Debtors	90,000
Bill receivable	100,000
Cash	70,000
Current Assets	<u>₦370,000</u>

Current liabilities are calculated from the balance sheet as follows:

	₦
Creditors	20,000
Bill payable	100,000
Accured expenses	5,000
Current Liabilities	<u>₦305,000</u>

Working Capital = Current Assets less Current Liabilities

$$\begin{aligned} \text{i.e. } & \quad \text{₦}37,000 - \text{₦}305,000 \\ & = \underline{\text{₦}65,000} \end{aligned}$$

18.5 Importance of Working Capital or the Significance of Circulating Working Capital

- (i) Working capital is the prime factor in profit earning with sufficient working capital, the profit earning capacity of the business is enhanced.
- (ii) Expansion of any business also depends on working capital. The higher the working capital, the greater the chance of growth and expansion because there will be enough resources to run the business.
- (iii) A company's credit worthiness can be determined by its working capital. The larger the working capital the more confidence creditors will have in the ability of the company to discharge its obligations.
- (iv) Working capital enables a business to absorb with ease the stock of adverse effects of shrinkage in the value of current assets resulting from bad periods of business.
- (v) Working capital can help a business to increase its sales as it can afford to give its customers favourable terms and credit facilities.
- (vi) A higher working capital helps a business to run efficiently as delays in the procurement of supplies on credit are avoided.

Summary

There is considerable agreement in the understanding of the concept of capital between the economist and the accountant as indicated in the following area:-

- (i) *Its meaning:* as man-made assets for further production of wealth.
- (ii) *Its scope:* goes beyond cash and to machinery, equipment, tools, etc.
- (iii) *Mode of capital formation:* by marriage of factors of production - labour, materials, capital and entrepreneurship.
- (iv) *Rewards:* both accept interests/dividends as rewards of capital.
- (v) *Complements of economic growth:* both agree that capital is essential for economic growth.

Revision Questions

A. *Essay Questions*

- 1. What is capital?
- 2. Give five importance of working capital in business management.
- 3. What is circulating capital? Discuss this from the view points of an economist and an accountant.
- 4. Explain the following 5 terms using the figures in the illustration given below:-
 - (i) Authorised Capital
 - (ii) Called-up Capital
 - (iii) Liquid Capital
 - (iv) Circulating Capital
 - (v) Paid-up Capital

Illustration

The Registrar of companies allowed the promoter of a company to raise a maximum capital of ₦20 million at ₦10.00 per share. To start with ₦1 million shares at ₦5.00 per share were called-up out of ₦1.5 million share of initial issues. All the shares called-up were fully paid. Of this initial capital, the current assets of the company carried the following value:

	₦
Stock	200,000
Debtors	100,000
Prepaid items	50,000
Cash in hand/at bank	70,000/150,000

B. *Objective Questions*

1. The reward of capital as a factor of production is
 - A. Commission
 - B. Interest
 - C. Profit
 - D. Rent
 - E. Wages

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2. Authorised capital is described as the
 - A. Actual amount of capital that shareholders have paid to the company.
 - B. Amount of money called up on the shares that have been subscribed.
 - C. Amount of money that a company is empowered to raise for business.
 - D. Amount of share capital which is actually issued for subscription.
 - E. Excess value of assets of a business over the value of its liability.

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3. Investors who are entitled to fixed rate of interest whether the company makes profit or not are known as
 - A. Debentures holders
 - B. Shareholders
 - C. Stockbrokers
 - D. Stockholders
 - E. Underwriters

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4. To an accountant, capital means
 - A. All man-made resources that are used for production of more wealth.
 - B. Money borrowed from banks to start a business.
 - C. Money required to invest in a business.
 - D. Money value of excess of business assets over liabilities.

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5. The type of payment which subscribers make as part-payment for shares allotted is called _____ capital.
 - A. Authorised
 - B. Called-up
 - C. Issued
 - D. Subscribed
 - E. Uncalled-up

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6. Founders™ shares is also known as _____ shares.
 - A. Cumulative Preferences

- B. Deferred
- C. Ordinary
- D. Participating Preference
- E. Preference

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7. Which is NOT a source of capital for business?

- A. Borrowing from somewhere
- B. Issuing of dividend warrant
- C. Retained profit
- D. Issuing of shares
- E. Personal savings

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8. Which of the following is the amount of capital a limited liability company must not exceed by law?

- A. Working capital
- B. Nominal capital
- C. Loan capital
- D. Fixed capital

WASSCE (2000)

9. Furniture and fittings used in a business are classified as

- A. Fixed Asset
- B. Circulating Capital
- C. Current Asset
- D. Working Capital

WASSCE (2000)

10. Capital plus profit minus drawings is equal to

- A. Fixed capital
- B. Liquid capital
- C. Capital owned
- D. Capital employed

WASSCE (2000)

Project

Find out if there are any companies in your locality and indicate those whose operations have been seriously hampered by lack of capital.