

ABM 302

# LESSON 6: OVERCAPITALIZATION & UNDERCAPITALIZATION: MEANING, CAUSES, EFFECTS & REMEDIES

Prof. Swami Prasad Saxena

Department of Applied Business Economics

Dayalbagh Educational Institute, Dayalbagh, Agra

Email: [spsaxena@dei.ac.in](mailto:spsaxena@dei.ac.in)

# OVERCAPITALIZATION

## Definition

“A company is overcapitalized when its earnings are not large enough to yield a fair return on the amount of stock and bonds that have been issued, or when the amount of securities outstanding exceeds the current value of the assets”.

*Gerstenberg*

## Symptoms

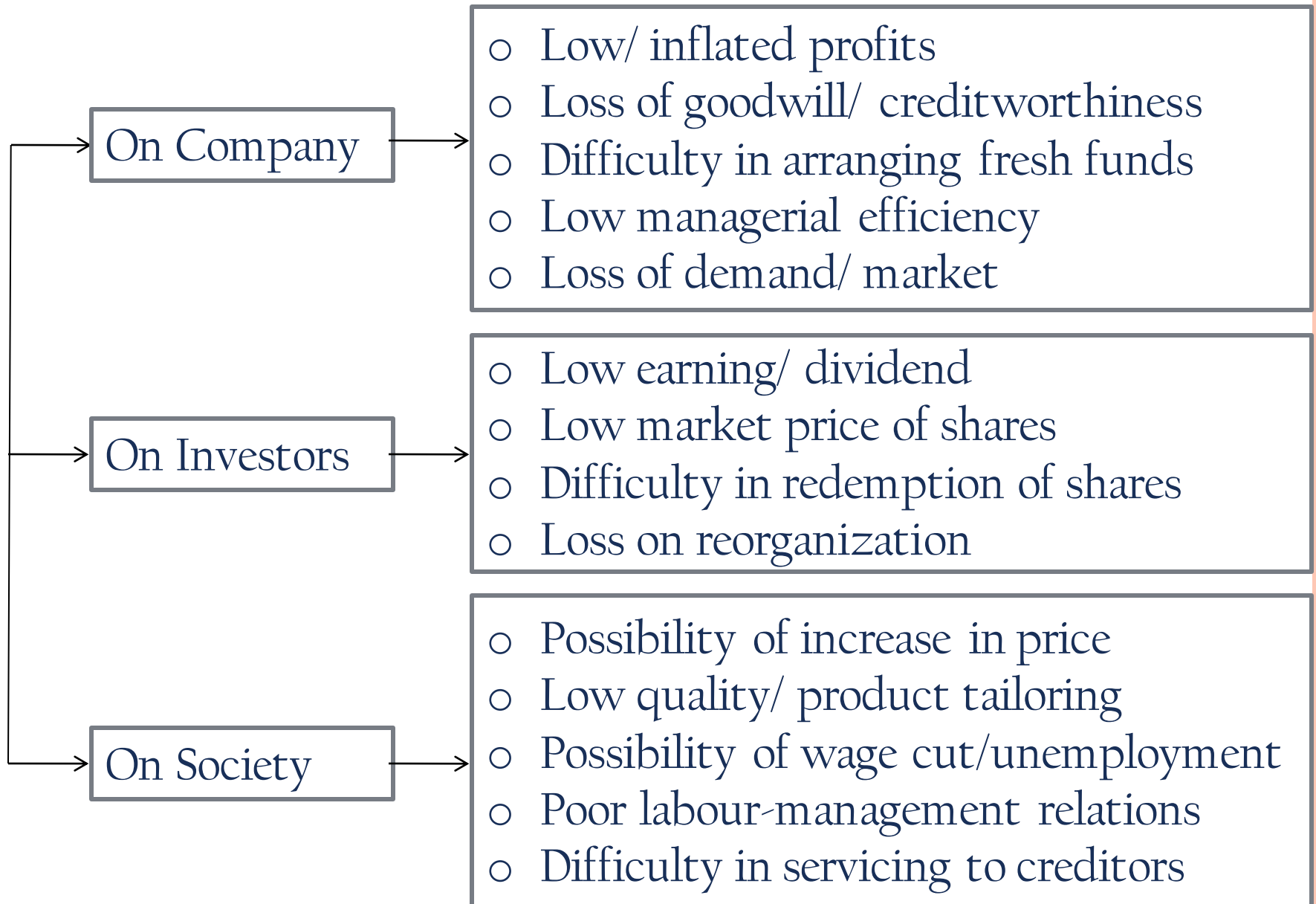
- Capitalization exceeds the real economic value of its net assets.
- Business has more net assets than it needs.
- Book value of assets is less than real value of assets.
- A fair return is not realized over a fairly long period.
- Market value of shares falls below par value over long period.

This situation is also called as “Watered Stock”.

## CAUSES OF OVERCAPITALIZATION

- Over-estimation of prospective income
- Under-estimation of capitalization rate
- Establishment of firm during inflationary period
- High promotion expenses
- Inadequate depreciation
- Liberal dividend policy
- High burden of tax due to inadequate policies
- Inefficient management
- Excessive competition in product market
- Unpredictive circumstances
- Unremunerative borrowing

# EFFECTS OF OVERCAPITALIZATION



# REMEDIES OF OVERCAPITALIZATION

- Reorganization and reconstruction
- Technological upgradation
- Product innovation and diversification
- Capital restructuring
- Debt conversion and debt redemption
- Loan repayment and settlement
- Redemption of preference shares
- Decrease in par value of shares
- Consolidation of shares
- Buy-back of shares
- Increase in managerial efficiency

# UNDERCAPITALIZATION

## Definition

“An enterprise may be undercapitalized when the rate of profit is exceptionally high in relation to the return enjoyed by similar situated enterprises in the same industry. The assets may be worth more than the values reflected in the books.”

*Gerstenberg*

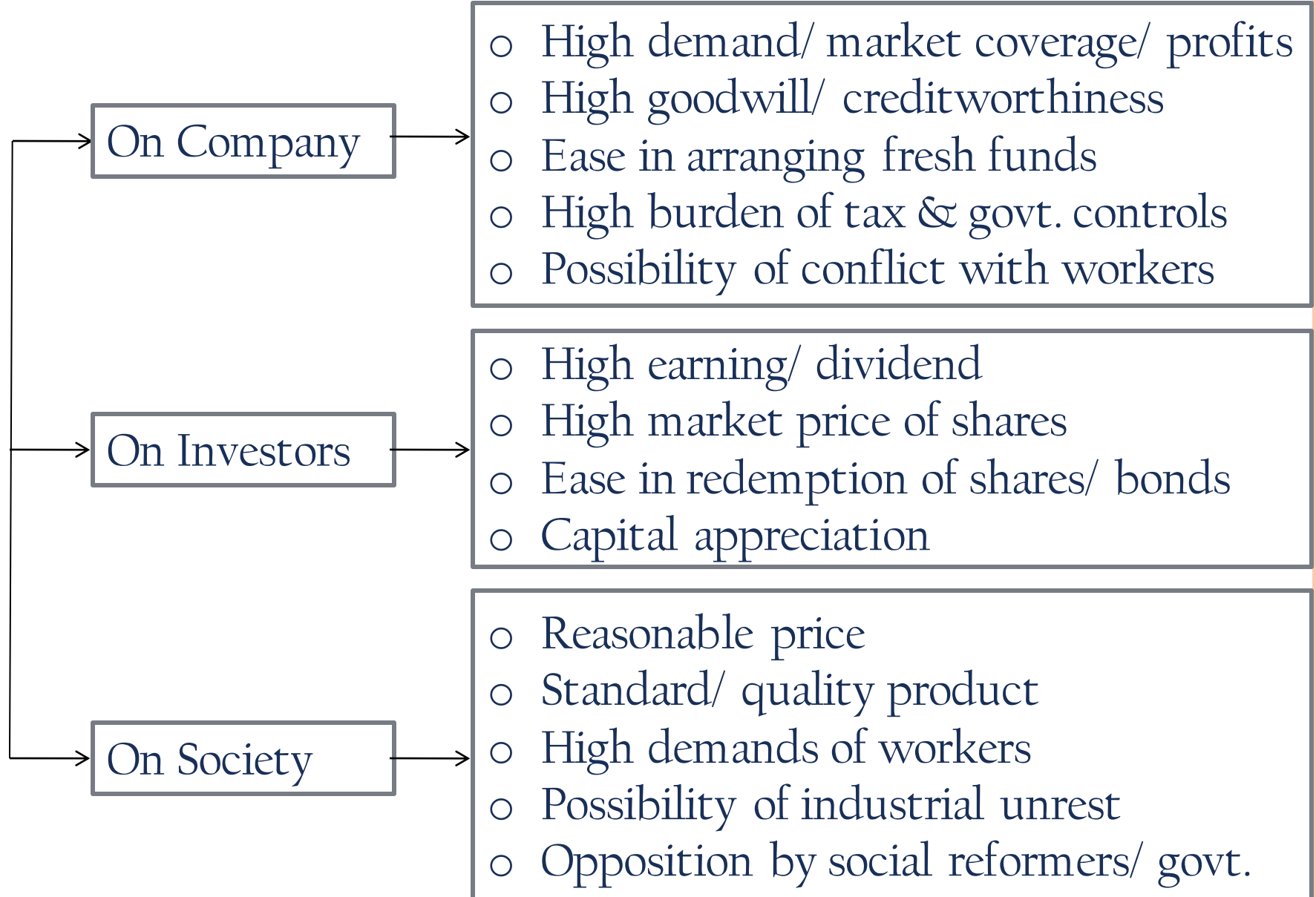
## Symptoms

- Firm's actual capitalization is less than fair capitalization.
- Book value of assets is significantly more than real value of assets.
- Firm's rate of return is much higher than fair RoR over a fairly long period.
- Market value of shares significantly more than par value.

## CAUSES OF UNDERCAPITALIZATION

- Under-estimation of prospective income
- Over-estimation of capitalization rate
- Establishment of firm during deflationary/ recessionary period
- Conservative dividend policy
- Desire to control and trading on equity
- High standards of efficiency
- Innovations and high standard of technology
- High image, goodwill and creditworthiness of firm

# EFFECTS OF UNDERCAPITALIZATION





## REMEDIES OF UNDERCAPITALIZATION

- Revaluation of assets
- Splitting-up of shares
- Issue of bonus shares
- Increase in par value of shares
- Issue of fresh capital (if justified)

Thank you...