

Undercapitalization

What is undercapitalization?

Under-capitalization is a situation, wherein the company has insufficient capital but large amount of secret reserve. There is generally appreciation in the value of land and building, plant, machinery, and goodwill etc. but the company does not show the appreciation in its books of accounts.

These assets earn handsome earning and the result in larger amount of profit in comparison to the capital invested. In case of under-capitalization, the full capacities of the enterprise cannot be exploited due to the shortage of funds. The rate of dividend and the value of shares are higher than the rate of dividend and value of shares of similar companies.

Example

Normal rate of return in the industry is 15%. The company earns a profit of \$30,00,000 and has employed a capital of \$1,00,00,000. The proper capital of the company for this profit of \$30,00,000 should be \$2,00,00,000. The company has been earning the same profit with a capital of \$1,00,00,000.

In this case, the company will be assumed to be under-capitalized to the extent of \$1,00,00,000. Undercapitalized companies earn profit at considerably higher rates than similar companies in the industry. The situation of under-capitalization may be compared to a lean, thin and weak person, who cannot run smoothly due to its weakness.

Disadvantages of Undercapitalization

Undercapitalized companies suffer from the following disadvantages.

- (i) Conflict between labour and management. Higher rate of earning encourages workers to demand higher increase in the wages. Management does not meet their demand fully, so the conflict between labour and management starts.
- (ii) Consumers' feeling of exploitation. Declaration of dividend at higher rates creates a feeling among Consumers that they are being exploited, because the company instead of decreasing price of the commodity is increasing the dividend rates.
- (iii) Manipulation in the value of shares. The management indulges in the manipulation of the value of shares and exploits shareholders.
- (iv) Higher rates of taxation. Earnings at higher rate attracts the government for levying taxes at higher rates.

Effects of Undercapitalization on Shareholders

1. Higher rate of returns. In case of undercapitalization rate of return payable to shareholders is higher. Dividend is paid at higher rates.
2. Higher value of shares. Due to higher rate of dividend declared by the company, the value of shares increases.

3. Increased liquidity of investment. Increased value of shares makes them liquid. These shares can be sold, whenever required because of their increasing price in the market.

Remedies to Eradicate Evils of Undercapitalization

The following measures should be adopted as remedial measures to eradicate evils of undercapitalization:

(i) Increase in the number of shares. Under this scheme of reorganization, the number of shares are increased thus the dividend per share falls.

(ii) Increase in the par value of shares. Under this method, the par values of shares are increased so the rate of dividend declines, but the dividend per share remains the same.

(iii) Issue of bonus shares. Issue of bonus shares increases the number of shares, so dividend per share and the rate of dividend falls.

Undercapitalization has also its own evil consequences but its consequences are not as fatal as in case of over-capitalization. Even then efforts should be made to reduce the pressure of undercapitalization.

Play Accounting