SECTION – 2

QUESTION-1.

ANSWER:-

Capital Structure:-

The term 'structure' means the arrangement of the various parts. So capital structure means the arrangement of capital from different sources so that the long-term funds needed for the business are raised.

Thus, capital structure refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a firm should raise to run its business.

Concept of Capitalization:

Capitalization refers to the valuation of the total business. It is the sum total of owned capital and bor-rowed capital. Thus it is nothing but the valuation of long-term funds invested in the business. It refers to the way in which its long-term obligations are distributed between different classes of both owners and creditors. In a broader sense it means the total fund invested in the business and includes owner's funds, bor-rowed funds, long term loans, any other surplus earning, etc. Symbolically:

Capitalization = Share Capital + Debenture + Long term borrowing + Reserve + Surplus earnings.

Different authors have defined capitalization in different ways but the theme of those definitions remains almost same. Some of the important definitions are presented below:

According to Guthmami and Dougall, 'capitalization is the sum of the par value of the outstanding stocks and the bonds'.

In the words of Walker and Baughen, 'capitalization refers only to long-term debt and capital stock, and short-term creditors do not constitute suppliers of capital, is erroneous. In reality, total capital is furnished by short-term creditors and long-term creditors'Bonneville and Deway define capitalization as 'the balance sheet values of stocks and bonds outstanding'.

Hence capitalization is the value of securities and may be defined as the par value of various obligations of a firm distributed over various classes of stocks, bonds, debenture and creditors.

Theories of Capitalization:

We have seen that capitalization refers to the determination of the value through which a firm is to be capitalized. In the context of capitalization there are two popular theories: Cost Theory and Earning Theory.

i. Cost Theory:

This theory is focused on the cost of acquiring assets. The total value of capitaliza-tion under the Cost Theory is the sum total of costs of acquiring both fixed and current assets. Under this theory the costs incurred for issue of shares and other securities are also included in capitalization.

Hence capitalization is the sum of land and building, plant and machinery and other fixed assets, stock of raw materials, debtors and other current assets and preliminary expenses. This theory is best used by a new firm as it helps to find the total amount of capital needed for establish-ing the business.

The theory suffers from the following limitations:

a) It highlights only the cost aspect but not the capacity of the assets;

b) It remains silent about time when the asset becomes obsolete; and

c) For a firm having fluctuating earnings, the theory loses its importance.

i. Earning Theory:

Under this theory the earning capacity of the business is considered as the basis of capitalization. According to this theory the capitalized value of earning of the firm is the amount of capitalization. Industry's representative rate of return is taken as the rate of capitalization.

The value of capitalization is calculated thus:

Capitalization = Average Annual Future Earnings / Capitalization Rate x 100

This theory also suffers from the following limitations:

Estimation of future earning for a new company is very difficult;

Rate taken for capitalization may not be proper representative of the firm; and

Mistake committed at the time of estimating the earnings will directly influence the amount of capitalization.