

KUNTHAVAI NAACHIYAR GOVERNMENT ARTS COLLEGE FOR WOMEN (A) THANJAVUR-7  
DEPARTMENT OF BUSINESS ADMINISTRATION

Code: 18K5BBELBB1- ENTREPRENEURIAL DEVELOPMENT

UNIT – III

Small scale industries in India – Definition, Objectives of SSI, Characteristics of SSI, Role of SSI in the economic development, Problems faced by SSI, Registration of SSI, Incentives available to SSI units in Backward or rural area. Reasons for industrial sickness, remedial measures to prevent sickness.

2-MARKS

1. small scale industries in India- Definition .

Small scale industries are labour intensive yet require little capital. ... Small scale industries comprise of small enterprises that manufacture goods or provide services with the help of smaller machines and a few workers and employees. The enterprise must fall under the guidelines set by the Government of India.

**2. Prevent sickness meaning:**

A range of approaches to reducing the risks of ill health and promoting good health. Illness-preventing man oeuvres. Educating one self and one's patients, making healthy lifestyle changes, behaviour modification, access to medication or other interventions that prevent disease onset.

5-MARKS

1. Explain the Characteristics of SSI:

Ownership: SSI 's generally are under single ownership. So it can either be a sole proprietorship or sometimes a partnership.

Management: Generally both the management and the control is with the owner/owners. Hence the owner is actively involved in the day-to-day activities of the business.

Labor Intensive: SSI's dependence on technology is pretty limited. Hence they tend to use labour and manpower for their production activities.

Flexibility: SSI's are more adaptable to their changing business environment. So in case of amendments or unexpected developments, they are flexible enough to adapt and carry on, unlike large industries.

Limited Reach: Small scale industries have a restricted zone of operations. Hence, they can meet their local and regional demand.

Resources utilization: They use a local and readily available resource which helps the economy fully utilize natural resources with minimum wastage.

2. List out the Objectives of SSI:

To create more employment opportunities.

To help develop the rural and less developed regions of the economy.

To reduce regional imbalances.

To ensure optimum utilisation of unexploited resources of the country.

To improve the standard of living of people.

To ensure equal distribution of income and wealth.

To solve the unemployment problem.

To attain self-reliance.

To adopt the latest technology aimed at producing better quality products at lower costs.

10-MARKS

**1. Discuss the Remediate measures to prevent sickness:**

1. Inadequacy of Working Capital: Some units turn out sick due to inadequacy of working capital.

*Source: Khanka .S.S – Entrepreneurship development*

There may exist delay in sanction of working capital by financial institutions. Industrial units find it difficult to meet out day to day operations due to the time gap between sanction of term loan and working capital needs. Shortage of working capital is one of the main reasons for sickness.

**2. Non-Availability Of Credit:**

Sickness in SSI sector may be attributed to non-availability of credit. Delay in getting loans may result in stoppage of work or lead to production loss. Low production may lead to reduced sales.

**3. Poor and obsolete technology:** Some industrial units use technology which is outdated. Out dated technology may affect the quantity and quality of production. This results in production loss and reduces demand for the goods.

**4. Non availability of raw material:** Some units may require raw material which are scarcely available. Sometimes, the raw material required by the unit may not be available in abundance.

**5. Marketing problems:**

Sometimes, the industrial units may not know as to how to create demand for the products. Lack of marketing knowledge may result in less demand for the goods. For example, lot of units producing dyes and ceramics has been found sick in Gujarat and tirupur.

**6. Erratic power supply:**

Shortage in power supply affects the industries. This results in delay in production of goods and leads to financial losses.

**7. Labour problems:**

The relationship between the employer and the employees may not be cordial. Some of the labour problems such as strike, lay off, lock out may lead.

**8. Poor Management:**

The entrepreneur must be a good planner, organizer and a manager. If the industrial unit promoters lack managerial skills, then it may lead to several problems.

**9. Inadequate attention to R&D:**

Industries have to allocate a part of money in research and development to survive and compete with competitors. Failure to focus on the above may lead to industrial sickness

**10. Diversion Of Resources:**

If the employer utilizes the funds obtained for the business for any personal purposes, then diversion of funds will lead to industrial sickness. The funds used for personal purposes cannot be regenerated and hence it may result in delay in payment of loans or financial crisis for the borrower of the loan.

**11. Globalization:**

Small scale industrial units may find it very difficult to compete with large scale industries and foreign competitors. Inability of the units to face growing competition due to liberalization and globalization may lead to industrial.

**2.Registration of SSI :**

SSI registration is a registration provided by the Ministry of MSME. A business should obtain SSI registration in order to be eligible for a number of schemes, subsidies and other incentives provided by the Government to such SSI's. SSI registration can be obtained online too. Let's look at the process of SSI registration online:

**Overview of SSI registration**

SSI registration is provided by the Ministry of Micro, Small and Medium Enterprises through the Directorate of Industries of the State Government. The main logic behind the SSI registration is to set up new SSI businesses in India. SSI registration helps the business to be eligible for a number of subsidies given by the Government. We can also get SSI registration online.

**2.Eligibility Criteria for SSI registration**

SSI registration can be obtained for:

- Manufacturing enterprise; and
- Service enterprise

**For manufacturing enterprise, if the investment in plant and machinery (excluding land & buildings) is within any of the following levels:**

**Micro Enterprises:** Investment of up to Rs.25 lakhs in plant and machinery

**Small Enterprises:** Investment of up to Rs.5 crores in plant and machinery

**Medium Enterprises:** Investment of up to Rs.10 crores in plant and machinery

**For service enterprise, if the investment in plant and machinery (excluding land & buildings) is within any of the following levels:**

**Micro Enterprises:** Investment of up to Rs.10 lakhs in equipment

**Small Enterprises:** Investment of up to Rs.2 crores in equipment

**Medium Enterprises:** Investment of up to Rs.5 crores in equipment

If the investment is done within the above-mentioned limits then the SSI registration has to be obtained.

### **3 .Explain the Benefits of obtaining SSI registration.**

There are various tax rebates offered to SSI's

A credit for Minimum Alternate Tax (MAT) is allowed to be carried forward for up to 15 years instead of 10 years

There are many government tenders which are only open to the SSI.

They get easy access to credit.

Once registered the cost of acquiring a patent, or the cost of setting up the industry reduces as many rebates and concessions are available.

Business registered as SSI are given higher preference for government license and certification.

#### **Business registered as SSI are given higher preference for government license and certification.**

To do the registration the SSI owner has to fill a single SSI online registration form. It can be done in the offline mode as well.

If a person wants to get registration for more than one industry then also he/she can opt for an individual SSI registration done.

To get registered he/she has to fill a single form which is available at the website.

The documents required for the SSI registration are Aadhar number, industry name, address, bank account details and some common information.

Here, the person can provide self-certified certificates.

No registration fees is required for the registration.

Once the SSI registration form is filled and uploaded, very soon you will obtain the SSI registration number.

## UNIT – IV

**Business Plan – meaning, Steps involved in preparing a business plan, Common errors in business plan formulation or project formulation.**

**Project classification- project identification-project selection. Project report- Contents of a project report- Stages in formulation of a project report.**

### 2-MARKS

#### **1. What is the Meaning of project?**

It is an attempt to implement desired change to an environment in a controlled way. By using projects we can plan and do our activities, for example: build a garage, run a marketing campaign, develop a website, organize a party, go on vacation, graduate a university with honors, or whatever else we may wish to do.

#### **2. What is mean by Business plan?**

There are many that make a good business plan, avoid these business plan mistakes and give your business idea the pitch it deserves. It often takes time, patience and many revisions before you get it right.

*Source: Khanka .S.S – Entrepreneurship development*

Unfortunately when rushing to get your funding in place and launch your business, your plan can get neglected. Below we have highlighted a few of the very common business plan mistake.

5-mark

### **1. Explain the steps involved in business plan.**

#### Step 1: Executive summary

This opening section kick starts your business plan and briefly outlines the key points of your plan. The goal here is to explain what your company does and why it will be successful. Include a company mission statement (i.e., what your ultimate goal is as a business, in just a sentence or two.)

#### Step 2: Business description

This section leads off the main portion of your business plan. In it, you'll go into more detail on what your company does and what solutions to brings to the marketplace. In this section, it's time to get specific and detail what product or services you're developing and what customers you're targeting. Include a brief history of your company and mention any top-level talent you have aboard to get your company off the ground.

#### Step 3: Market analysis

In this section, you'll detail the marketplace you'll be competing in. Where are the best opportunities in your market? What is the marketplace? Who are your competitors? What are their strengths and weaknesses? What is the leading marketplace product or service and what are you doing to improve on the leading products or services? Financing companies want to work with differentiators, and they'll want to know what separates your business from the pack. Here's the place to tell them exactly that.

#### Step 4: Company organization

How will your company operate (i.e., as a partnership or as a corporation, primarily) and who will be the key decision makers? How will the company be structured legally? What is the management hierarchy? Who has ownership of the company and at what percentage? These are the primary questions you'll need to answer in the company organization section of your business plan.

**Step 5: Products or services provided** What will your company produce and how will it benefit customers? What kind of research and development have you already put into your company and what results are you getting - and expecting? Also, how will you market your product or service to customers? These are the questions you'll need to answer in this section.

#### Step 6: Financial outlook

In this section, you'll need to lay out your financial projections for your company. If your company is already up and running, list any income statements and cash flow numbers for the past several years, if possible. Do you have any loans outstanding? What does your balance sheet look like? What are your quarterly projections going forward? Company funders consider this the most important section of your business plan, so be thorough and as accurate as possible in presenting financial data to your readers - they'll be pouring over every word and every digit to judge whether there's a good business opportunity here or not.

**Step 7: Summary** Close your business plan with a pitch for funding, and list any supporting data, graphs and charts that bolster your pitch. Make it clear what you're looking for financially from financiers - equity, a partnership or a loan. Provide a ballpark estimate of the funding you need and make it clear whether you're open to a negotiation. A company that knows how much money it needs will be taken as a serious on.

### **2. Mention the project identification:**

a discrete set of activities identified as important within programme-based activities, a country's poverty reduction strategy and/or sector-wide approach

*Source: Khanka .S.S – Entrepreneurship development*

problems or constraints in the development process caused by shortages of essential facilities, services, and material or human resources and by institutional or other obstacles

unused or underused material or human resources and opportunities for their conversion to more productive purposes; or, conversely, overused natural resources that need to be conserved or restored

unsatisfied demands or needs and possible means to meet them including opportunities arising from new technology or technological development, for example, the internet and mobile telephony

the need to complement other investments (such as providing railway and port links for a mining project, transport, packing and marketing facilities for an agricultural development project, or access roads for a sugar factory and bio-ethanol plant)

**Project ideas may also emanate from**

initiatives by local private or public entrepreneurs who wish to take advantage of opportunities they perceive or who are responding to government incentives

community initiatives (often supported by national or international NGOs)

a government response to local political or social pressures originating, for example, from economic, social, or regional inequalities

a need for advocacy aimed at government in a weak policy environment

the pursuit of national objectives such as food security

the occurrence of natural events (drought, floods, earthquakes) and the short-term responses to crisis

as a response to long-term trends such as migration, environmental degradation, and climate change

a desire to create a permanent local capability to carry out development activities

by building up local institutions

**Finally, project ideas originate not only from within a country but also from abroad as a result of**

investment proposals of multinational firms

programming activities of bilateral and multilateral aid agencies and their ongoing projects in the country

influence of investment strategies adopted by other developing countries as well as opportunities created by international agreements (for example, on the use of offshore resources)

prevailing professional opinion or public consensus within the international community in such fields as population, environment, and the alleviation of poverty

10-mark

**1. Describe the common errors in business plan.**

**1. Unrealistic Financial Projections:**

Most Canadians are familiar with the businesses on CBC's Dragons' Den who grossly overestimate the value of their company and are chastised and shot down by the dragons. It's one of the most common business plan mistakes. Lenders and investors expect to be shown a realistic picture of where your business is now and where it hopes to be, therefore if the plan is overly optimistic with no explanation of the projections, it will ring warning bells and cause the plan to be rejected.

**2. Not Defining the Target Audience**

No business will appeal to everyone. You must define your specific target market, present how you have made these assumptions and outline how you will specifically target this market.

Need help defining your target market and learning about primary and secondary market research? Small Business BC offers seminars on market research and one-on-one

**3. Over-Hype:**

You may believe your business idea is the next big thing but you need to be able to back-up your claim. Over-hyping your business idea and littering your plan with superlatives like hottest and greatest does not substantiate your product or service. Wow them with you business idea, research and financial plan, not with the words you think they want to hear.

*Source: Khanka .S.S – Entrepreneurship development*

#### **4. Bad Research:**

All research must be double checked and substantiated. By using incorrect or out of date information you will discredit your business idea and the remainder of the plan.

#### **5.No Focus on your Competition:**

Even if you think you have a 'unique' business idea and are sure that no other business like yours exists, check and double check. There is no such thing as no competition. Even if your business is one of kind, it comes down to the dollar; if your business didn't exist, but the customers' need still existed, where would they spend their money?

Equally if you highlight your competition too much the investor will worry that the business will not survive. Focus on your niche, what differentiates you from the competition, how you plan to compete in the marketplace and paint accurate picture of what the industry is like now and where you see it going in the future.

#### **6.Hiding your weakness:**

Do not hide your weaknesses but do not highlight them too much. Every business has its weaknesses but by hiding them or high

#### **7. Not Knowing your Distribution Channels:**

Have a secure plan how to provide your service or distribute your product. Including all possible channels in your plan without substantiating why these are the correct channels and how they will reach your target market will make the investor assume that you have just thought of the list off the top of your head. The ability to articulate your strategy about how your product or service will reach your client is vital.

#### **8. Including Too Much Information:**

If you were an investor, would you want to read a 200 page business plan? Most investors have a mental checklist of 10 to 12 points that they are looking for in the plan, everything else just gets in the way. The purpose of your plan is not to demonstrate the depth of your knowledge but to focus on the key elements of your business. Clear and concise writing is always appreciated and if you have additional information which you would like to include in the document, create an appendix.

#### **9. Being Inconsistent:**

Highlighting different target markets, quoting conflicting statistics or having competing strategies within a plan will make an investor challenge whether you know your business and its market well enough. Sections of plans are often written on different days or by different people and then pasted together into one document resulting in inconsistency. Take time to review each section of your business plan.

#### **10. One Writer, One Reader:**

Make sure you ask several people to review your plan before submitting it. It is easy for you to glaze over spelling mistakes and grammatical errors because you know the information inside

## **2. What are the Stages in formulation of a project report?**

### **1. General Information:**

A project report must provide information about the details of the industry to which the project belongs to. It must give information about the past experience, present status, problems and future prospects of the industry. It must give information about the product to be manufactured and the reasons for selecting the product if the proposed business is a manufacturing unit. It must spell out the demand for the product in the local, national and the global market. It should clearly identify the alternatives of business and should clarify the reasons for starting the business.

### **2. Executive Summary:**

A project report must state the objectives of the business and the methods through which the business can attain success. The overall picture of the business with regard to capital, operations, methods of functioning and execution of the business must be stated in the project report. It must mention the assumptions and the risks generally involved in the business.

### **3. Organization Summary:**

The project report should indicate the organization structure and pattern proposed for the unit. It must state whether the ownership is based on sole proprietorship, partnership or joint stock company. It must provide information about the bio data of the promoters including financial soundness. The name, address, age qualification and experience of the proprietors or promoters of the proposed business must be stated in the project report.

#### **4. Project Description:**

A brief description of the project must be stated and must give details about the following:

- \*Location of the site,
- \*Raw material requirements,
- \*Target of production,
- \*Area required for the workshed,
- \*Power requirements,
- \*Fuel requirements,
- \*Water requirements,
- \*Employment requirements of skilled and \*unskilled labour,
- \*Technology selected for the project,
- \*Production process,
- \*Projected production volumes, unit prices,
- \*Pollution treatment plants required.

If the business is service oriented, then it must state the type of services rendered to customers. It should state the method of providing service to customers in detail.

#### **5. Marketing Plan:**

The project report must clearly state the total expected demand for the product. It must state the price at which the product can be sold in the market. It must also mention the strategies to be employed to capture the market. If any, after sale service is provided that must also be stated in the project. It must describe the mode of distribution of the product from the production unit to the market. Project report must state .

#### UNIT – V

Sources of finance-Internal sources and external sources. Sources of Term loans. Sources of short term finance. Factors determining capital structure. Under capitalization-Causes , effects and Remedies of under capitalization. Tax benefits to small scale industries.

2-MARKS

#### **1. What mean by Under capitalization?**

Undercapitalization occurs when a company does not have sufficient capital to conduct normal business operations and pay creditors. This can occur when the company is not generating enough cash flow or is unable to access forms of financing such as debt or equity.

#### **2.What is External source of finance :**

External sources of finance refer to money that comes from outside a business. There are several external methods a business can use, including family and friends, bank loans and overdrafts, venture capitalists and business angels, new partners.

#### **5- MARKS**

#### **1.State the sources of finance.**

##### **☞Internalsources**

##### **☞Externalsources**

#### **1.Internalsources:**

Under this sources,funds are raised from within the enterprise itself.The internal sources of financing couldbe owner's capital known as equity,deposit and loans given by the owner, the partners,the directors,as the case maybe,to the enterprise.One sources for raising funds internally maybe personal loans taken by entrepreneur on his/her personal assets like provident fund,

*Source: Khanka .S.S – Entrepreneurship development*

life insurance policy, building, investment, etc. In addition to these, in case of a running enterprise, funds could also be raised through the retention of profits or conversion of some assets into funds. The cardinal principle of official management also suggests that an entrepreneur should religiously plough back a good portion of his/her profits into the enterprise itself. However, the scope for raising funds from internal sources particular in the case of small-scale enterprise remains highly limited.

## **2. External sources:**

In short, funds raised from other than internal sources are from external sources. The external sources usually include the following:

1. Personal funds or Equity capital.
2. Loans from relatives and friends.
3. Mortgage loans.
4. Term-loans.
5. Subsidiaries.

## **2. Explain the Tax benefits to small scale industries.**

Under section 80J of the Income Tax Act 1961, new industrial undertakings, including small-scale industries, are exempted from the payment of income-tax on their profits subject to a maximum of 6% per annum of their capital employed. This exemption in tax is allowed for a period of five years from the commencement of production.

**A small-scale industry has to satisfy the following two conditions to avail of this tax exemption facility:**

1. The unit should not have been formed by the splitting or reconstruction of an existing unit.
2. The unit should employ 10 or more workers in a manufacturing process with the power or at least 20 workers without power.

## **Depreciation:**

Under Section 32 of the Income Tax Act, 1961, a small-scale industry is entitled to a deduction on depreciation account on block of assets at the prescribed rate. Small enterprise is allowed subject to a maximum of Rs. 20 lakh deduction for depreciation on plant and machinery on the diminishing balance method. In case of an asset acquired before the accounting period, depreciation is calculated on its written down value. For plant and machinery that are used in manufacturing in double or triple shift, an additional allowance called 'Extra Shift Allowance' is also available.

**A small-scale industry should satisfy the following conditions before it becomes eligible for deduction in depreciation:**

1. The assets must be owned by the assessee.
2. The assets must actually be used for the purpose of the assessee's business or profession.
3. Depreciations allowance or deduction is allowed only on fixed assets, i.e. building machinery, plant and furniture. From assessment year 1991-92, in the case of a company, depreciation will be limited to Rs. 7,590/- of the amount calculated at the specified percentage on the written down value block of assets

10-MARKS

## **1. Describe the factors that determining capital structure.**

### **1. Cash Flow Position:**

The decision related to composition of capital structure also depends upon the ability of business to generate enough cash flow.

The company is under legal obligation to pay a fixed rate of interest to debenture holders, dividend to preference shares and principal and interest amount for loan. Sometimes company makes sufficient profit but it is not able to generate cash inflow for making payments.

The expected cash flow must match with the obligation of making payments because if company fails to make fixed payment it may face insolvency. Before including the debt in capital structure company must analyse properly the liquidity of its working capital.

*Source: Khanka .S.S – Entrepreneurship development*



A company employs more of debt securities in its capital structure if company is sure of generating enough cash inflow whereas if there is shortage of cash then it must employ more of equity in its capital structure as there is no liability of company to pay its equity shareholders.

## **2. Interest Coverage Ratio (ICR):**

It refers to number of times companies earnings before interest and taxes (EBIT) cover the interest payment obligation.

$ICR = \frac{EBIT}{Interest}$

High ICR means companies can have more of borrowed fund securities whereas lower ICR means less borrowed fund securities

## **3. Debt Service Coverage Ratio (DSCR):**

It is one step ahead ICR, i.e., ICR covers the obligation to pay back interest on debt but DSCR takes care of return of interest as well as principal repayment. If DSCR is high then company can have more debt in capital structure as high DSCR indicates ability of company to repay its debt but if DSCR is less then company must avoid debt and depend upon equity capital only.

## **4. Return on Investment:**

Return on investment is another crucial factor which helps in deciding the capital structure. If return on investment is more than rate of interest then company must prefer debt in its capital structure whereas if return on investment is less than rate of interest to be paid on debt, then company should avoid debt and rely on equity capital. This point is explained earlier also in financial gearing by giving examples.

## **5. Cost of Debt:**

If firm can arrange borrowed fund at low rate of interest then it will prefer more of debt as compared to equity.

## **6. Tax Rate:**

High tax rate makes debt cheaper as interest paid to debt security holders is subtracted from income before calculating tax whereas companies have to pay tax on dividend paid to shareholders. So high end tax rate means prefer debt whereas at low tax rate we can prefer equity in capital structure.

## **7. Cost of Equity:**

Another factor which helps in deciding capital structure is cost of equity. Owners or equity shareholders expect a return on their investment i.e., earning per share. As far as debt is increasing earnings per share (EPS), then we can include it in capital structure but when EPS starts decreasing with inclusion of debt then we must depend upon equity share capital only.

## **8. Floatation Costs:**

Floatation cost is the cost involved in the issue of shares or debentures. These costs include the cost of advertisement, underwriting statutory fees etc. It is a major consideration for small companies but even large companies cannot ignore this factor because along with cost there are many legal formalities to be completed before entering into capital market. Issue of shares, debentures requires more formalities as well as more floatation cost. Whereas there is less cost involved in raising capital by loans or advances.

## **9. Risk Consideration:**

Financial risk refers to a position when a company is unable to meet its fixed financial charges such as interest, preference dividend, payment to creditors etc. Apart from financial risk business has some operating risk also. It depends upon operating cost; higher operating cost means higher business risk. The total risk depends upon both financial as well as business risk. If firm's business risk is low then it can raise more capital by issue of debt securities whereas at the time of high business risk it should depend upon equity.

*Source: Khanka .S.S – Entrepreneurship development*

**10. Flexibility:**

Excess of debt may restrict the firm's capacity to borrow further. To maintain flexibility it must maintain some borrowing power to take care of unforeseen circumstances.

**11. Control:**

The equity shareholders are considered as the owners of the company and they have complete control over the company. They take all the important decisions for managing the company. The debenture holders have no say in the management and preference shareholders have limited right to vote in the annual general meeting. So the total control of the company lies in the hands of equity shareholders.

If the owners and existing shareholders want to have complete control over the company, they must employ more of debt securities in the capital structure because if more of equity shares are issued then another shareholder or a group of shareholders may purchase many shares and gain control over the company.

Equity shareholders select the directors who constitute the Board of Directors and Board has the responsibility and power of managing the company. So if another group of shareholders gets more shares then chance of losing control is more.

**12. Regulatory Framework:**

Issues of shares and debentures have to be done within the SEBI guidelines and for taking loans. Companies have to follow the regulations of monetary policies. If SEBI guidelines are easy then companies may prefer issue of securities for additional capital whereas if monetary policies are more flexible then they may go for more of loans.

**13. Stock Market Condition:**

There are two main conditions of market, i.e., Boom condition. These conditions affect the capital structure especially when company is planning to raise additional capital. Depending upon the market condition the investors may be more careful in their dealings. During depression period in the market business is slow and investors also hesitate to take risk so at this time it is advisable to issue borrowed fund securities as these are less risky and ensure fixed repayment and regular payment of interest but if there is Boom period, business is flourishing and investors also take risk and prefer to invest in equity shares to earn more in the form of dividend.

**14. Capital Structure of other Companies:**

Some companies frame their capital structure according to Industrial norms. But proper care must be taken as blindly following Industrial norms may lead to financial risk. If firm cannot afford high risk it should not raise more debt only because other firms are raising.

**2. Discuss the under capitalization -causes, effects and remedies.****☛ Causes of under capitalization:****1. Under-Estimation of Capital Requirements:**

If the future capital requirements are under-estimated by the promoters, the inadequacy of capital is experienced at a later stage. The company may arrange cheaper debt at lower rate of interest at that stage resulting in increased earnings per share. This leads the company to a situation of under-capitalisation.

**2. Under-Estimation of Future Earnings:**

While preparing the financial plan, if the future earnings of the company are under estimated and the actual earnings turn out to be higher than the estimated figure, the company may find itself in a condition of under-capitalisation.

**3. Promotion during Depression:**

*Source: Khanka .S.S – Entrepreneurship development*

Companies promoted during a period of depression often experience under-capitalisation when inflation sets in because of a sudden rise in their earnings.

#### **4. Conservative Dividend Policy:**

If the management of a particular company adopts an orthodox dividend policy, i.e. where it follows a cautious policy regarding the distribution of dividend and keeps a major part of its earnings for re-investment purpose, it results into higher earnings and conditions of under-capitalisation.

#### **5. Very Efficient Management:**

In companies, where the management is very efficient, the rate of return may be quite high as compared to other companies in the same industry, and such a high rate of return may eventually lead towards under-capitalisation.

#### **6. Desire of Control and Trading on Equity:**

In many companies, the promoter desires to retain control over the company and raises lesser amount of share capital. However, later on when the funds are required they resort to trading on equity. This raising of funds at a lower rate of interest than the earnings of the company eventually leads to under-capitalisation.

#### **☞ Effects of under capitalization :**

1. Under-capitalisation induces management to change and manipulate the market value of shares and expanding the business.
2. As a consequence of under-capitalisation, earnings per share increase and so do the dividend per share, which in turn, increases the marketability of shares.
3. When the employees find that the company is earning high profits they press for higher wages and as a result, a tiff between the workers and employers takes place giving rise to labour unrest.
4. As a consequence of under-capitalisation, the companies earn huge profits and as a result, the burden of tax is great. The government introduces higher rate of taxation which is a financial burden on the companies.
5. Higher profits earned by the companies give a psychological feeling to the customers that they are being over-charged and hence they develop grouse towards that company.
6. Higher earnings may encourage competitors to enter into a cut-throat competition amongst themselves.
7. A situation of over-trading by the company may arise as a result of under-capitalisation, where the company does excessive business than what its finances can allow.
8. As a result of over-trading, creditors will not be paid timely and the company will effect its creditworthiness adversely.
9. Under-capitalisation eventually leads to over-capitalisation because of excessive profits, huge retained earnings and long-term debt financing.

#### **☞ Remedies for under capitalization:**

##### **1. Fresh Issue of Shares:**

If under-capitalisation is due to inadequacy of capital, then it can be corrected by the issue of fresh shares, the company may also redeem its long-term debt by the issue of fresh share capital.

##### **2. Issue of Bonus Shares:**

The company may issue bonus shares by capitalising its accumulated earnings. This is the most commonly used and effective method of correcting under-capitalisation. It reduces earnings per share after the bonus issue.

### **3. Increasing the Par Value of Shares:**

The company may revalue its assets and increase their values. In lieu, thereof, the par value of shares may also be increased. This will result into reduction of earnings per rupee of share value but the amount of dividend per share will remain same.

### **4. Splitting Stock.**

Another effective method of correcting under-capitalisation is to split up the existing stock into larger number of shares reducing the value of each share. It neither affects the total earnings of the company nor the total amount of capital of the company but still dividend per share shall reduce.