Concept of Capitalization

Capitalization in Finance:

In finance, capitalization in finance is the sum of a company's debt and equity. It represents the capital invested in the company, including bonds and stocks.

Capitalization can also mean market capitalization. Market capitalization is the value of a company's outstanding shares of stock. It also represents the value of the firm according to investors' perceptions. It is equal to the number of shares outstanding multiplied by the share price.

Market Capitalization = Shares Outstanding x Share Price

Shares outstanding

the number of **shares outstanding** represents the amount of **stock** on the open market, including **shares** held by institutional investors and restricted **shares** held by insiders and company officers.

What is Capitalization?

Capitalization is an accounting method in which a cost is included in the value of an asset and expensed over the useful life of that asset, rather than being expensed in the period the cost was originally incurred. In finance, capitalization refers to the cost of capital in the form of a corporation's stock, long-term debt, and retained earnings. In addition, market capitalization refers to the number of outstanding shares multiplied by the share price.

Capitalization in Accounting

In accounting, capitalization refers to recording costs as assets on the balance sheet instead of as expenses on the income statement. A company may record the purchase price of an asset, as well as the asset's acquisition costs, such as transportation and setup, as assets on the balance sheet.

Capitalization in accounting also refers to transferring an off-balance-sheet operating lease onto the balance sheet and recording it as a capital lease. To do this, calculate the present value of the future operating lease payments and record the amount on the balance sheet as an asset with a corresponding liability.

(acquisition capital as the capital used to acquire other assets. You use this capital to purchase assets like equipment, inventory, software, or even a business itself. Acquisition capital is used in one of two situations: when the growing business does not itself have the cash to grow or when the growing business will experience greater firm value from financing the purchase as opposed to paying out of the free cash flow of the company.

Acquisition Capital Debt

One of the two main forms of acquisition capital is debt financing. Many describe debt financing more commonly as a loan. When someone is paid back, usually with interest, in the form of loan payments rather than dividend payments one can be sure that debt financing is being used. In this way, an acquisition loan works the same as any other loan.

You can find acquisition capital, in the form of debt, through a variety of sources. First, one could simply access friends and family who can spare the money needed for the loan. We suggest that a business person do this under a specific agreement. Unfulfilled business agreement have damaged many close relationships.

Funding

Next, funding can come in the form of a bank loan. This will, for anyone who does not have access to a wealthy personal contact, almost always be the cheapest form of capital. One can access better interest rates, often, through government lending programs like the Small Business Association (SBA) or Patriot Express loans.

Often thought, mezzanine debt providers act as the middle ground between debt and equity financing. Here, one can receive a loan without collateral. Additionally, the loan contract also allows conversion of the debt to company common stock. Mezzanine debt, however, bears a higher interest rate due to the riskiness of the investment. It is usually provided by venture capital firms or private equity funds.

Asset based lending is another option for financing for acquisition. With an asset based lender, company uses their assets as collateral to back loans. The major disadvantage with this method is that using assets for collateral means that when loan agreements are not met, the assets are seized by the lending party. Logically, if the assets of a growing business are taken it is considerably more difficult to continue growth, if not all operations.

Acquisition Capital Equity

Equity financing is another form of acquisition capital. Rather than receiving a loan which must be paid back, a company which receives equity financing provides company stock, either common or preferred, for the capital it receives. Equity financing is, essentially, payment in exchange for partial ownership in a company. Private equity and venture capital firms, the common providers of equity capital, will receive payback for their investment in one of 2 ways: company cash disbursements in the form of dividends or profit from the final sale of the company which includes their ownership stake. This means, often times, that equity financiers will take greater involvement in the company they have invested in.

Acquisition Capital Example

For example, Eddy has started and grown a successful restaurant chain. Fighting the odds, he has grown his company from a single small shop to several locations. Using the recipes his grandmother once cooked, Eddy brings delicious food to the city while protecting his trade secrets. Recently, demand for his food has outpaced his ability to produce it. Eddy is now considering acquiring restaurants which serve French food, the cuisine that has risen him to success. Despite this goal, Eddy does not currently have the money to finance his own growth and will need acquisition capital to continue growing his business.

First, Eddy evaluates receiving a bank loan. He meets with a banker, an old high school friend, to discuss options for funding. Sadly, he discovers that he does not have the assets necessary to receive the standard bank loan. The bank will need to see, beyond Eddy's dream, operations which Eddy has not yet achieved.

Eddy does research on Mezzanine and asset based lending. Here, he finds that he also does not qualify. For mezzanine, Eddy can not afford the interest rates required by lenders. For asset backed lending, Eddy does not have the proper set of company assets to convince the lender that he is worth their risk. Even if he did, Eddy does not see much benefit in promising away his tools for success.

Equity Financing

Eddy then evaluates equity financing. He looks at local and national private equity firms. Here, he finds experience requirements which he does not meet. Additionally, these firms will want increased control over Eddy's business operations. Eddy is concerned that this might take away from his home-style cooking which has gained attention near his brick-and-mortar locations.

As Eddy is evaluating equity financing, he attends a family reunion. Here, he sees his uncle Ted for the first time in a while. An experienced restauranteur in his own right, Ted has also created a successful restaurant chain which serves Cajun food. Eddy has a very pleasant conversation with Ted and eventually expresses his needs. Ted, wealthy from his success, offers the idea that he could finance the budding series of French kitchens. They discuss the concerns of becoming business partners connected by blood relations. Though this is worry some, the two driven entrepreneurs resolve to continue the conversation later in the week.

Eddy looks forward to talking with Ted. By accessing friends and family, usually the cheapest and easiest of all forms of financing, he may be able to provide success for more than just himself. Additionally, Ted's experience makes him a wealth of knowledge on acquisition; best practices are key to creating the standards that customers expect. Eddy makes a mental plan of what he will need to prepare in order to convince his uncle that he is worth an acquisition funding.)

Understanding Capitalization

Capitalization has two meanings in accounting and finance. In accounting, capitalization is an accounting rule used to recognize a cash outlay as an asset on the balance sheet, rather than an expense on the income statement. In finance, capitalization is a quantitative assessment of a firm's capital structure.

KEY TAKEAWAYS

- In accounting, capitalization occurs when a cost is included in the value of an asset.
- In finance, capitalization or book value is the total of a company's debt and equity.
- Market capitalization is the dollar value of a company's outstanding shares and is calculated as the current market price multiplied by the total number of outstanding shares.

Capitalization in Accounting

In accounting, the matching principle requires companies to record expenses in the same accounting period in which the related revenue is incurred. For example, office supplies are generally expensed in the period when they are incurred since they are expected to be consumed within a short period of time. However, some larger office equipment may provide a benefit to the business over more than one accounting period. These items are fixed assets, such as computers, cars, and office buildings. The cost of these items are recorded on the general ledger as the historical cost of the asset. Therefore, these costs are said to be capitalized, not expensed.

Capitalized assets are not expensed in full against earnings in the current accounting period. A company can make a large purchase but expense it over many years, depending on the type of property, plant, or equipment involved. As the assets are used up over time to generate revenue for the company, a portion of the cost is allocated to each accounting period. This process is known as depreciation or amortization.

For leased equipment, capitalization is the conversion of an operating lease to a capital lease by classifying the leased asset as a purchased asset, which is included on the balance sheet as part of the company's assets. The Financial Accounting Standards Board (FASB) issued a new Accounting Standards Update (ASU) in 2016 that requires all leases over twelve months to be both capitalized as an asset and recorded as a liability on the lessee's books, to fairly present both the rights and obligations of the lease.

Generally, a company will set "capitalization thresholds." Any cash outlay over that amount will be capitalized if it is appropriate. Companies will set their own capitalization threshold because materiality varies by company size an industry. For example, a local mom and pop store may have a $500 capitalization threshold, while a global technology company may set their capitalization threshold at $10,000.

Financial statements can be manipulated when a cost is wrongly capitalized or expensed. If a cost is incorrectly expensed, net income in the current period will be lower than it otherwise should be. The company will also pay lower taxes in the current period. If a cost is incorrectly capitalized, net income in the current period will be higher than it otherwise should be. In addition, assets on the balance sheet will be overstated.

Capitalization in Finance

Another aspect of capitalization refers to the company's capital structure. Capitalization can refer to the book value cost of capital, which is the sum of a company's long-term debt, stock, and retained earnings. The alternative to the book value is the market value. The market value cost of capital depends on the price of the company's stock. It is calculated by multiplying the price of the company’s shares by the number of shares outstanding in the market.

If the total number of shares outstanding is 1 billion and the stock is currently priced at $10, the market capitalization is $10 billion. Companies with a high market capitalization are referred to as large caps (more than $10 billion); companies with medium market capitalization are referred to as mid caps ($2 - $10 billion); and companies with small capitalization are referred to as small caps ($300 million - $2 billion).

It is possible to be overcapitalized or undercapitalized. Overcapitalization occurs when earnings are not enough to cover the cost of capital, such as interest payments to bondholders or dividend payments to shareholders. Undercapitalization occurs when there's no need for outside capital because profits are high and earnings were underestimated.