Section 01. Modern Economics

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Capitalization and Its Role for a Company

A lot of publications both by Ukrainian and foreign scientists are devoted to the issues of capitalization. Being an ambiguous, multifaceted economic phenomenon, capitalization is important for the growth of the national economy. The world experience shows that the complex index of business reputation, financial stability, attractiveness, profitability, corporate governance, image of the company is just an indicator of its capitalization.

Ukrainian scientist M. A. Kozoriz is investigating capitalization as a process of transformation of surplus value into capital and as evaluation of the market value of the company (Fig. 1).

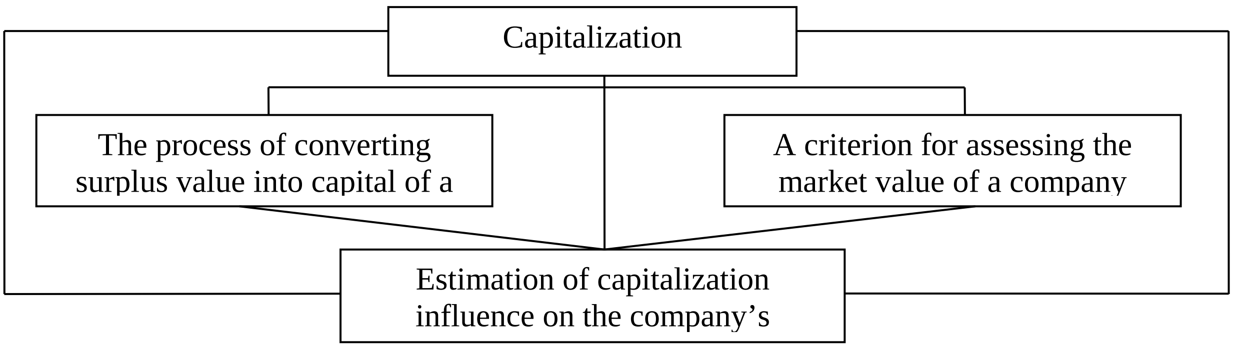

Figure 1 - Kozoriz methodological approach to capitalization [2]

Summarizing different interpretations of the term “capitalization”, currently used by foreign researchers, the following three definitions can be given:

1. Capitalization of costs happens when a company spends money to purchase or upgrade fixed assets. The expenditures are recorded as an asset on the balance sheet.
2. Invested capital implies a sum of corporate shares, retained earnings and long-term loans and debts.
3. Market capitalization is an indicator of market value of the enterprise. Capitalization is calculated by multiplying the exchange price of the shares on the number of outstanding shares.

In practice, in industry and business capitalization is the process of increasing assets of a company. To understand how it happens, we should first divide assets into two groups:

- assets, such as inventory, equipment and property to be generated in the future economic benefits of the company;

- assets, such as cash, investments and receivables to be exchanged for another assets.

Capitalization is possible only in the first group of assets.

In the U.S. Internal Revenue Code provides recommendations which help distinguish the costs from capital expenditures. The U.S. Code § 263A – “Capitalization and inclusion in inventory costs of certain expenses” identifies four types of costs related to material property to be capitalized:

- new property with more than one year lifespan;
- expenses that provide benefits for the company even after the end of the fiscal year;
- capital expenditure on property improvements increasing its value or prolonging its lifespan;
- adjustments to the real estate that allow to use it for another purpose.

Under the types of costs listed above expenditure on intangible assets of the company is also possible. According to the International Accounting Standard № 38 “intangible asset is an identifiable non-monetary asset without physical substance, which brings future economic benefits, and can be sold or made available to rent” [5].

Capitalization of intangible assets may significantly overestimate the carrying value of the enterprise. It will influence the company's balance sheet indicators, income statement and cash flow statement. The consequences of capitalization are spread to a number of financial indicators, such as: cash flow from operations, assets reported on the balance sheet, net income, stockholders' equity, profitability indicators, liquidity ratios, ratio of capital turnover, solvency ratio etc.

The decision concerning capitalization is made by the management of the company. It is a serious management problem, which depends on a number of important financial ratios. Correct decision directly affects the financial stability of the company.

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