Accounting and overdraft theory practice

An overdraft is when one has overdrawn at the bank. Meaning there is a negative balance due to spending more than themoneythat is in the bank. Bank overdraft is a temporary facility whereby a bank customer can withdraw more money than what is actually available in his/her account. Obviously the money doesn't belong to them but belongs to the bank, so this money will need to be paid back. Normally, paying back is automatically done when money goes into the person's account.

However, a small amount of interest based on the amount overdrawn and the length of time overdrawn is charged, a bank overdraft is also a type of loan which can be used if required to provide additional working capital for a short period of time when there is a cash deficit. An overdraft is particularly useful when one has regular sales and purchases coming out of the account which could result in bad cash flow situations. The best thing to do is to avoid overdrafts entirely.

Do this by creating a budget, keeping an extra cash cushion in your account, managing your checkbook and checking your balance before making a purchase or writing a cheque. The advantage of a bank overdraft is that it is there when you need. It allows you to make essential payments whilst chasing up for your own payments, and helps to maintain cash flow. You only need to borrow what you need at the time. Overdrafts are also easy and quick to arrange, providing a good cash flow backup with the minimum of fuss.

The disadvantages of a bank overdrafts is that it carries an interest and fees which is often at much higher rates than loans. This makes them very expensive for long term borrowing. You also face large charges if you go over the agreed overdraft limit. Unless specified in the terms and conditions, the bank can recall the entire overdraft at any time. This may happen if you fail to make other payments, or if you have broken terms and conditions; though sometimes the banks simply change their policies.

Overdrafts may need to be secured against your business assets, which put them at risk if you cannot meet repayments. Unlike loans you can only get an overdraft from the bank where you maintain your current account. In order to get an overdraft elsewhere you need to transfer your business bank account. Situation: Mr. T applied for an overdraft facility with collateral. He mortgaged his house in order to get an overdraft facility of RM200, 000 with an interest of BLR-2. 2% with HSBC Bank (BLR-Base lending rate).

RM200, 000 is deposited into his account upon the completion of security documentation. Interest is only payable for the amount of money utilized and he is given a tenor of 10 years to repay back. If he does not utilize the RM 200, 000, he need not pay any interest to the bank for that month. The bank only calculates interest for the utilized amount only on a daily basis. However, if he doesn’t utilize any money, the bank may impose a service charge. This type of overdraft facility is best for businessman.