

Overtrading: finance and capital essay sample

[Finance](#)



Overtrading means a situation of operating a business with insufficient long term capital to support the current volume of business. A situation in which a company is growing its sales faster than it can finance them. Overtrading often occurs when companies expand their own operations too quickly aggressively. Overtrading can arise even if the organization is trading profitably. Over-expansion of business is one of the main reasons for overtrading and therefore overtrading is also called under-capitalization. In other words, Overtrading means transacting more business than the firm's working capital can normally sustain, placing serious strain on cash flow and risking collapse or insolvency.

SYMPTOMS OF OVERTRADING:

Although one cannot say for sure whether a company is overtrading or not, just by looking at its financial statements, and or performing simple ratio analysis of the organisations financial statements, the financial statement is still one of the most useful external source of information that may be available to an external stakeholder in making a decision as to whether a company may be overtrading or not.

The two main causes of overtrading are:

1. Insufficient funds increasing credit sales volume.
2. Poor management practices/inefficient management.

The other symptoms are:

* Extended credit sales period taken by customers, than industry average. *

Increasing sales without corresponding increase in profit. * Increasing

inventory days, excessive investment in inventory, probably with no immediate need. * Increasing and excessive reliance on trade payables as a source of funds for working capital needs. * Extended trade payables periods, sometime the company takes involuntary trade payables period. * Lack of cash in hand or at bank, hence excessive reliance on bank overdraft as a major source of finance for working capital activities. * Increasing working capital cycle.

* Increasing sales without corresponding increase in long-term sources of capital in the form of bonds and / or equity. * Decrease in the company's liquidity ratios such as current ratio and quick ratio.

Below are some ratios that can be computed to investigate whether a company is overtrading or not:

- * Stock (inventory) days
- * Debtor (trade receivable) days
- * Creditor (trade payable) days
- * Current ratio
- * Quick ratio
- * Gross profit margin
- * Net profit margin
- * Return on capital employed

IMPACT OF OVERTRADING:

* Many businesses become insolvent because they try to accommodate everyone who wishes to purchase their products. This ultimately leads to not being able to pay for the financing costs used to produce the goods and a <https://assignbuster.com/overtrading-finance-and-capital-essay-sample/>

lack of working capital to finance operations. * Rapid growth in business development and sales.

* Lesser net profit. * The business running a business with limited knowledge. * Cash flow problem or short of working capital. – {scenario is that cash inflows from sales (especially sales on credit!) come in too late to pay suppliers for the increase in stocks required. Another common scenario (in construction for example), wages may have to be paid, and equipment and material obtained, long before a customer pays for work completed.} * Bad cash budget or unrealistic.

* Having large amount of unpaid vendors.

* High amount of financial interest expenditure.

* High gearing ratio.

* Keen market competition.

* Overstock or slow movement of inventory.

POSSIBLE REMADIES

To remedy overtrading, the main causes of it must be identified and measures put in place to reverse, and or reduce its reoccurrence. This may include proper management practises, where management are properly trained and know the effects of such poor management of working capital that are in place. 1. One way to protect yourself from overtrading (churning) is through a wrap account – a type of account that is managed for a flat rate rather than charging commission on every transaction. 2. Businesses can avoid overtrading through good planning (that they can ensure that resources are available when required, before problem occur) and by being <https://assignbuster.com/overtrading-finance-and-capital-essay-sample/>

well financed (for example, funds are available for to increase working capital if required).

3. Efficient working capital management such as; Efficient inventory controls (EOQ, JIT, maximum stock levels, Re-order level, minimum stock level) 4.

Efficient receivable management (checking credit worthiness of customers, prompt invoicing, use of factor services, invoice discounting etc . . .) 5.

Proper cash management – arranging for different sources of finance, to overcome come of the insufficient funding problems, such source of funds may include, using leasing, hire purchase, short-to-medium-term loans, bank overdraft. 6. In the long-term, the company may consider raising more equity finance by obtaining listing on the stock market, either on the AIM, or the main market etc, . . .