Business failure by overtrading

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Remarkable sales figures and improved short-term profits do not necessarily indicate ongoing success of a business.

Strange as it might seem, fast growth is not always sustainable and may damage the cash flow and the profitability of a business in the longer term, especially if the business is in its developing stage, or if the business does not have the adequate resources to satisfy the increase in demand.

Unfortunately, sudden increase in growth motivates business owners to meet such growth and encourages them to invest further in new assets and other resources depending on the nature of their business - such as bigger premises, more machinery and IT equipment, stock and vehicles while taking on more people. Very often, however, business owners will have to borrow more money to finance the newly employed assets and to compensate for the increased costs required to meet such increase in growth.

This new investment may then result in business insolvency, since the increase in sales is beyond the capability of financing such investment with the normal working capital generated by the business itself.

This leads to the definition of overtrading, which every business owner should be aware of and keep in mind to prevent potential business failure achieved by overtrading: ***"Selling more than a business is capable of dealing with in terms of finance and other required resources"***.

Overtrading, which admittedly is often the result of lack of management competence and lack of adequate capital to run the business, presents a potential problem to the creditors of the business.

Creditors should therefore identify the real reason behind every request for credit, especially when such requests come from the existing debtors demanding extension of credit, or if new market entrants apply for a relatively large amount of money. This may be a clear, and early indication of overtrading!

One method which indicates whether the business of a credit applicant is adequately proportionate to the sales volume is the Net Sales to Tangible Net Worth Ratio. Tangible Net Worth refers to the owners' equity less any intangible assets. This ratio may potentially indicate any credit or management problems relating to overtrading.

However, there are several other issues by which the creditor may identify overtrading:

Significant drop in the profit margins - It may happen that the increased costs, incurred to meet the demand increase of the business over the last months, effect negatively the bottom line of the business.

Sharp rise in the variable costs - Variable costs vary directly in proportion to the level of sales turnover. Depending on the type of business, some examples of such costs would be cost of goods sold, sales commissions, shipping charges, delivery charges, costs of direct materials or supplies, and sales or production bonuses. In order to meet new orders, the business owner may opt for more expensive goods and services, which would result in an increase in turnover to meet the demand at the expense of profitability.

Higher fixed costs - When the business struggles to meet the fixed costs, it may well be another sign of overtrading. Fixed costs are those costs which remain the same regardless the level of sales. Typical examples would be rent, interest on debt, insurance, plant and machinery expenses, and salaries.

Considerable increase in the customer base - Increasing the customers in a short period of time without enhancing the capabilities of the business is the ideal recipe for business failure due to overtrading. Although businesses should grow, they should be managed to grow steadily and progressively in proportion to the increase in their resources.

Increase in the workforce to meet new orders - Increase in demand may only be temporary. Employing people to meet an unexpected increase in demand may lead to internal disturbances in terms of financial and human resources. The business owners should analyse and review the market environment and establish the reasons of any increase in demand. New employment should be sustainable in the long-term, hence it is wiser to refuse orders in the short-term than to employ more staff to meet new orders without any serious evaluation.

Recent investment - The same concept of increasing the workforce to meet new orders applies. Investment in new premises or in any other asset should only be done after a feasibility study is conducted.

If the new investment is to be financed from an external source, it must be ensured that the cash inflows generated by the investment will be greater than the cost of capital required for the investment.

Banker refuses to extend the overdraft facility - Creditors should ensure that there was no refusal of a banking facility. The banker of the business is in a much better position in the market to monitor closely the business' finances. So, if the banker refuses to grant a loan or extend an overdraft facility, the trade creditor should recognise that a higher element of risk exists in the business, and a probable reason for such a banker's refusal may be due to overtrading.

The business taking longer to pay than it used to - Another very common indication is when a business takes longer to pay due to recent cashflow problems. Cash inflows will be absorbed by the increased costs and the business will fail to honour payments due to its suppliers on time.

The creditors should therefore learn how to recognise and identify the symptoms of overtrading to prevent overdue debtors accounts if not also bankrupt debtors.

The faster a business grows, especially when growth is financed by external sources, the more likely it is that the business will be destabilised. Businesses should monitor the cost of sales and aim for steady growth on an ongoing process.

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