Financial Ratios and the Over-Trading Trap

In a recent **Innoverto / BMTG Finance For The Non Finance Manager MasterClass** we were discussing the application (and mis application!) of Financial Ratios. One of the delegates related a story about a tender process in which he had just participated.

His company, a Consulting Engineering Group, was responding to a Government tender for Engineering Services. As part of the process they were asked to complete a generic questionnaire. The information being requested was then assessed but without regard to the nature of the tender or of the type of company seeking to win the tender.

One question had puzzled the delegate. He was asked to provide his company's stock turnover ratio and its current ratio. The delegate had requested the relevant numbers from his finance team and submitted them along with the other required information.

The document was returned by the Government Department. On it was written, "Stock turnover…..1/5, Current Ratio….3/5, total score….4/10…SUBMISSION REJECTED"

"What does that mean?" queried the delegate.

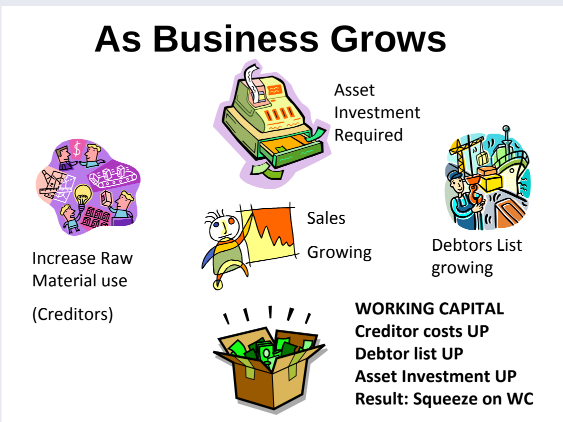
Turnover Ratio, Current Ratio and Over-Trading

Well, the combination of Turnover Ratio and Current Ratio is often used to detect whether a company is undertaking over-trading (a topic also covered in the Finance For The Non Finance Manager's course).

Over-trading represents an attempt by a company to maintain or expand its business operations without sufficient cash resources. Firms involved in over-trading have a high turnover ratio & a low current ratio. When a company get's caught in the over-trading trap it is not in a position to finance the maintenance of proper stocks of materials, finished goods, etc., and ends up depending almost entirely on it's suppliers to supply materials to them at the right time.

Over-Trading is frequently associated with a rapidly growing company where orders are growing strongly, perhaps necessitating additional capital expenditure to fund increased manufacturing capacity and requiring more raw material purchases and larger finished goods stocks for shipping. Such a scenario requires additional cash resources to fund accounts payable ....however an expanding order & shipping book is also likely to see an increase in cash receivables, i.e. outstanding invoices yet to be paid by clients.

The result is a **working capital cash crunch**!



Unfortunately, a successful and rapidly growing company is not the only cause of over-trading. Cash resources may get depleted through faulty financial policies such as premature repayment of long term loans, excessive drawings, excessive dividend payments, purchase of fixed assets (from working capital) or excessive net trading losses .

Whether you are a supplier to, or customer of a company involved in over-trading, there are potential problems for your relationship. As a supplier you may find that your invoices are not paid on time since the company is relying on you to fund their inventory, while they manufacture, sell and collect the sales proceeds. Additionally a supplier may find themselves subject to 'unreasonable' last minute supply demands as the over-trading company indulges in "Just In Time" (JIT) inventory management in order to avoid having to finance its stock. As a customer of an overtrading company you may find you have unfavorable credit terms as the company is under pressured to receive payment for their goods and services in the shortest possible time. Such a company can be an unreliable supplier to you if cash shortages prevent them from delivering goods & services to you.

Was the Client's Assessment Fair?

So let's return to our delegate. Was his company fairly assessed by 'scoring' each ratio and then 'failing' the combined score? **Probably not!!** Over-trading is generally a symptom experienced by manufacturing companies. Trying to identify over-trading by a service company is problematic using a stock turnover ratio since such companies carry little inventory as part of their service delivery. By definition, their stock is human capital! (In this case billable consulting hours.)

Ratios are best used to analyze the relative financial performance of 'like' companies (e.g. all the companies in a particular industry sector), or to monitor the performance of a single company over several financial periods. Even so, Ratios should be used with caution. A ratio has both a numerator and a denominator (e.g. Stock turnover = Sales/Inventory) and changes in either will affect the ratio. Changes should be examined carefully to correctly identify the cause.

Comparing ratios of unrelated companies is generally meaningless. There is no 'correct' ratio value, although norms can usually be established within industry groups.

As the delegate later commented, "I wish I'd done this course before we submitted that tender. I'd have known what they were trying to detect and I would have spent more time explaining the ratios provided. Perhaps that would have prevented their 'tick box' assessment and our elimination from the tender."

Meet the Author: Martin Ashe

Martin became involved in mainstream asset management, first with Macquarie Bank in Sydney, Australia then with the Rothschild family in Hong Kong. Later, as General Manager of Australia's Challenger International, he implemented the first organisation wide operational Risk Management program for the Group.

In 2004 Martin set up his own fund management company, IMFML Australia, (later acquired by the Allco Group).. In 2009 Martin moved to Singapore and has worked with Oxley Capital, a Singapore based boutique investment firm focussing on property, financial services and alternative energy projects..

Since April 2012 Martin has consulted to Wealth Management & Listed Property (REIT) Managers. Martin has conducted multiple Finance & Wealth Management training programs.