Over-Trading and Under-Trading

Over-trading and under-trading are the facets of over P-capitalization and under-capitalization.

Over-trading

Over trading means a situation w here a company does more business than w hat its finances allow . The result of over-trading is disastrous as it gives rise to increase in size, diminishing margin of safety and feeling a sense of stress and strain. Thus it is advisable for every company to carry on its business in terms of the financial resources that it has and not to do more business or trading than its finances permit. Over- trading is an aspect of under-capitalization.

A company which is under-capitalized w ill try to do too much with the limited amount of capital which it has. For example it may not maintain proper stock of stock. Also it may not extend much credit to customers and may insist only on cash basis sales. It may also not pay the creditors on time. One can detect cases of overtrading by computing the current ratio and the various turnover ratios. The current ratio is likely to be very low and turn-over ratios are likely to be very higher than normally in the industry concerned.

Overtrading can be defined as "Transacting more business than the firm's working capital can normally sustain, thus placing serious strain on its cash flow and risking collapse or insolvency."

Overtrading is a term in financial statement analysis. Overtrading often occurs w hen companies expand its ow n operations too quickly (aggressively). Overtraded companies enter a negative cycle, w here increase in interest expenses negatively impact net profit leads to lesser w working capital leads to increase borrowings leads to more interest expense and the cycles continues. Overtraded companies eventually face liquidity problems and/or running out of working capital.

Under Trading

Conditions/Symptoms of Over-trading:

- Rapid grow the in business development and sales.
- Lesser net profit.
- The business running a business with limited know ledge.
- Cash flow problem or short of w working capital.
- 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

Under-trading is the reverse of over-trading w here the funds of a company are not utilized fully because of insufficient management. This is due to the under employment of assets of the business, leading to the fall of sales and results in financial crises. This makes the business unable to meet its commitments and ultimately leads to forced liquidation. The symptoms in this case would be a very high current ratio and very low turnover ratio. Under-trading is an aspect of over-capitalization and leads to low profits, low rate of return on investment, decline in the share prices in the market, loss of good will etc.

Capitalization

Capitalization comprises of share capital, debentures, loans, free reserves, etc. Capitalization represents permanent investment in companies excluding long-term loans. Capitalization can be distinguished from capital structure. Capital structure is a broader term and it deals with qualitative aspect of finance, while capitalization is a narrower term and it deals with the quantitative aspect.

Capitalization is generally of the following two types:

- Over Capitalization
- Under Capitalization

Over-capitalization

Meaning of Over-capitalization:

Overcapitalization is a situation in which actual profits of a company are not sufficient enough to pay dividends at a proper rate on shares over a period of time. This situation arises when the company raises more capital than what is actually required. In such a situation, a part of the total capital of the company always remains idle and it results in lower earnings.

Causes of Over-capitalization:

The main causes of overcapitalization are:

1. High promotion cost- When a company goes for high promotional expenditure, i.e., making contracts, canvassing, underwriting commission, drafting of documents, etc. and the actual returns are not

adequate in proportion to high expenses, the company is over-capitalized in such cases.

2. Purchase of assets at higher prices- When a company purchases assets at an inflated rate, the

3. result is that the book value of assets is more than the actual returns. This situation gives rise to over-capitalization of company.

4. A company's floatation n boom period- At times company has to secure it's solvency and

5. thereby float in boom periods. That is the time when rate of returns are less as compared to capital employed. This results in actual earnings lowering down and earnings per share declining.

6. Inadequate provision for depreciation- If the finance manager is unable to provide an adequate

7. rate of depreciation, the result is that inadequate funds are available when the assets have to be replaced or when they become obsolete. New assets have to be purchased at high prices which prove to be expensive.

8. Liberal dividend policy- When the directors of a company liberally divide the dividends into the

9. shareholders, the result is inadequate retained profits which are very essential for high earnings of the company. The result is deficiency in company. To fill up the deficiency, fresh capital is raised which proves to be a costlier affair and leaves the company to be over- capitalized.

10. Over-estimation of earnings- When the promoters of the company overestimate the earnings

11. due to inadequate financial planning, the result is that company goes for borrowings which cannot be easily met and capital is not profitably invested. This results in consequent decrease in earnings per share.

Effects of Over-capitalization

On Shareholders

Over capitalization has the following effect on shareholders:

- Since the profitability decreases, the rate of earning of shareholders also decreases.
- The market price of shares goes down because of low profitability.
- The profitability going down has an effect on the shareholders. Their earnings become uncertain.
- With the decline in goodwill of the company, share prices decline. As a result shares cannot be marketed in capital market.

On Company

Over capitalization has the following effect on the company:

1. Because of low profitability, reputation of company is lowered.
2. The company's shares cannot be easily marketed.
3. With the decline of earnings of company, goodwill of the company declines and the result is fresh borrowings are difficult to be made because of loss of credibility.
4. In order to retain the company's image, the company indulges in malpractices like
5. manipulation of accounts to show high earnings.

The company cuts down its expenditure on maintenance, replacement of assets, adequate depreciation, etc.

On Public

1. Overcapitalization has the following adverse effects on the public:

2. j. In order to cover up their earning capacity, the management indulges in tactics like increase in prices or decrease in quality.

3. Return on capital employed is low. This gives an impression to the public that their
4. financial resources are not utilized properly.
5. Low earnings of the company affects the credibility of the company as the company is not able to pay it's creditors on time.
6. It also has an effect on working conditions and payment of wages and salaries also lessen.

Remedies for Over-capitalization:

Restructuring of the firm is to be executed to avoid the overcapitalization situation of the company. It involves:

- Reduction of debt burden/ Reduction of funded debts.
- Negotiation with term lending institutions for reduction in interest obligation/ Reduction of interest on debentures and loans.
- Redemption of preference share through a scheme of capital reduction. Reduction of the face value and paid-up value of equity shares. Reduction in the number of equity shares.
- Ploughing back of profits.
- Initiating merger with well managed profit making companies interested in talking over ailing company.

Undercapitalization

An undercapitalized company is one which earns exceptionally high profits as compared to industry. An undercapitalized company situation arises when the estimated earnings are very low as compared to actual profits. This gives rise to additional funds, additional profits, high goodwill, and high earnings and thus the return on capital shows an increasing trend.

Causes of Undercapitalization

The main causes of undercapitalization are:

- Low promotion costs
- Purchase of assets at deflated rates
- Conservative dividend policy
- Floatation of company in depression stage
- High efficiency of directors
- Adequate provision of depreciation
- Large secret reserves are maintained.

Effects of Under Capitalization

1. On Shareholders

a. Company's profitability increases. As a result, rate of earnings go up.
b. Market value of share rises.
c. Financial reputation also increases.
d. Shareholders can expect a high dividend.

2. On company

- With greater earnings, reputation becomes strong.

- Higher rate of earnings attract competition in market.
- Demand of workers may rise because of high profits.
- The high profitability situation affects consumer interest as they think that the company is overcharging on products.

3. On Society

- With high earnings, high profitability, high market price of shares, there can be unhealthy speculation in stock market.
- ‘Restlessness in general public is developed as they link high profits with high prices of product.
- Secret reserves are maintained by the company which can result in paying lower taxes to government.
- The general public inculcates high expectations of these companies as these companies can import innovations, high technology and thereby best quality of product.

Remedies for Under-capitalization:

The possible corrections for under-capitalisation may be outlined as under:

- Splitting up of the shares: The effect of this measure will be more apparent than real because the overall rate of earnings in this case will remain the same though the dividend per share will now be a smaller amount. Thus, split up of the company’s shares will reduce the dividend per share.
- Issue of bonus shares: This will reduce both the dividend per share and earning per share of the company. The most widely used and effective remedy for under capitalisation is the conversion of reserves and accumulated profits into shares. This will affect both dividend per share and the over-all rate of earnings.

- Increase in par value of shares: The values of assets, under this scheme, may be revised upwards and the existing shareholders may be given new shares carrying higher par (face) value. In this way, the rate of earnings will decline though the amount of dividend per share may not be affected. As a further step, the com pay may offer the shareholders a share split- up and an increase in par-value.

In short, the remedies of under-capitalisation are:

- Splitting up of shares.
- Increasing the number of shares. Increase in the par value of shares. Issue of Bonus shares.
- Fresh issue of shares.

Both over-capitalization and under-capitalization are detrimental to the interests of the society.