

The following financial information relates to Wobnig Co.

Income statement extracts

	2011	2010
	\$000	\$000
revenue	14525	10375
cost of sales	10458	6640
	-----	-----
profit before interest and tax	4067	3735
interest	355	292
	-----	-----
profit before tax	3712	3443
taxation	1485	1278
	-----	-----
distribution profit	2227	2165
	-----	-----

statement of financial position extract

	2011	2011	2012	2012
	\$000	\$000	\$000	\$000
non-current assets		15284		14602
<u>current assets</u>				
inventory	2149		1092	
trade receivables	3200		1734	
	-----		-----	
		5349		2826
		-----		-----
total assets		20633		17428
		-----		-----
<u>current liabilities</u>				
trade payables	2865		1637	
overdraft	1500		250	
	-----		-----	

		4365	1887
<u>equity</u>			
ordinary shares	8000	8000	
reserves	4268	3541	
	-----	-----	
		12268	11541
<u>long term liabilities</u>			
7% bonds	4000	4000	
		-----	-----
total liabilities		20633	17428

Average ratios for the last two years for companies with similar business operations to Wobnig Co are as follows:

Current ratio	1.7 times
Quick ratio	1.1 times
Inventory days	55 days
Trade receivables days	60 days
Trade payables days	85 days
Sales revenue/net working capital	10 times

Required:

Using suitable working capital ratios and analysis of the financial information provided, evaluate whether Wobnig Co can be described as overtrading (undercapitalised).

Examiners Report

This question asked whether a company (Wobnig Co) was overtrading and a good place to start an answer would be to state what overtrading was and how it could be recognised. This would then provide a basis for financial analysis of the information provided and a discussion of the findings. Most answer to this question gained good marks.

Answers that did not focus on the question asked, which was whether or not the company was overtrading, lost marks as a result. For example, some answer discussed, often in detail, how the company could improve its working capital position. These answers were wasting time, because this was not the question that was asked.

So discussing the possibility of offering discounts for early settlement, the loss of goodwill from trade suppliers, and the need to look for obsolete stock was a waste of time and not the way to gain marks in this question.

The question provided a list of average ratios for companies similar to Wobnig Co. Most answers calculated these ratios for each of the two years of financial statement data provided by the question, using the average ratios for similar companies to assist in commenting on the trend showed by Wobnig's ratios.

Since overtrading (undercapitalisation) refers to an increased level of business activity that is supported by too small a capital base, answers needed to look at how long-term finance had not kept pace with the increased need for finance, leading to increased reliance on short-term finance such as an overdraft or trade credit. This and other signs of overtrading are discussed in detail in the suggested answer.