

Case 9: Overtrading: profits but no cash

A small regional advertising agency specialized for many years in buying space in local papers and selling it to small businesses that wanted to place advertisements. In a way it performed a service of aggregation and of dealing with large volumes of enquiries. For this service it made a small margin, employed several people and provided its shareholders with a small return on their investment. It also added value and income through some low-level design work and copy work. There was little financial risk and the company had, by and large, operated on 30-days' credit. It was allowed 30 days to pay invoices received from the newspapers and allowed some of its own customers 30 days. Most small customers paid as they ordered an advertisement and accordingly the agency was generally in funds. It had a small overdraft facility but rarely needed to use it.

The directors decided to find new income streams. Their existing business was coming under threat as more people placed advertisements directly with publishers online. They decided that the agency needed to provide more services and increase the value of their offerings. They would protect and develop their existing customer base, and attract new customers by offering web design, copywriting, marketing strategy, branding, PR and other services. Their ambition was to become a full service agency.

The company had not in the past needed a finance director and had simply used a bookkeeping service and a firm of local accountants to prepare and file year-end accounts. A finance director was the last thing on their minds at first and they quickly recruited very able people to undertake the work and an experienced business developer. Things got off to a good start and in no time at all orders for work were flowing into the agency.

The work commanded good rates and the margins were much higher than had previously been earned on buying space in local newspapers and selling on. The directors produced management reports that showed high levels of sales and profits. On the basis of this the company took on more orders and recruited more staff. There was no shortage of work and profits.

However, the company started to run into cash-flow problems because, although it had a full order book and was charging out at a high

margin, there was a delay in collecting debts. Customers were slow to pay and were taking on average between 60 and 90 days credit. This lag did not match the agency's outgoings, which were 30 days. The new staff and premises were a regular monthly cash outflow.

The company was trading profitably but it was trading beyond its cash resources. It was overtrading. It could not pay its debts as they fell due and collapsed. It had left it too late to go to the bank and arrange facilities. The bank now just saw a company unable to pay its staff and rent, and was not about to jump in and save the day since it had no assurance on the quality and ability of the agency's customers to pay the debts. The company sacked most of its staff and started again in a restructured and better-financed manner.

You would have heard the saying that sales are vanity, profits are sanity but cash is king. Well it is not a bad thing to remember. Overtrading is a common cause of collapse of profitable companies.