THEBENCHMARK

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Let's talk money and cash flow

There's an old song by the band Simply Red called "Money's too Tight to Mention." Why do I mention this? Because the chickens of three years of lower prices have come home to roost in the form of tight cash flow for many contractors this spring … and money is too tight to mention.

The combined effect of overhead and capital requirements, in relation to lower gross margins, is biting profits — ergo cash flow.

A little math helps us understand the roots of the problem and solution. Table 1 outlines the calculations. In the "Old Days" column when pricing and gross profit margins were good (Line B), contractors could afford to live at benchmark numbers of 25% Overhead to Revenues (Line D), 45 day accounts receivable (Line E), and equipment returns of $8 of revenue for every dollar of annual capital equipment costs. As the "These Days" column shows, those benchmarks at 45% gross margins lead to negative cash flow.

We need new benchmarks to get there.

As Table 1 demonstrates in the "Future Days" column, we need to see improvement in all these numbers. Overhead cost to revenue can only be 20% to 22% of revenues (See the Frank Ross Chart of Accounts for indirect and administrative expenses), accounts receivable (working capital) must average 30 to 35 days maximum, and revenue to equipment must be at least $9 for every dollar of annual capital equipment costs.

Less overhead with better systems and fewer staff, faster billing and collection, and slightly extended life and equipment care can make it happen. Just being a little better in these three areas improves cash flow and gets you a few more restful nights of sleep.

Now, I have that darn song going through my head and probably won't be able to sleep tonight.

TABLE 1: THE CALCULATIONS

Financial number	Old days		These days		Future days	
A Revenue growth		$100,000		$100,000		$100,000
B Gross margin		55%		45%		45%
C Gross profit dollars		$55,000		$45,000		$45,000
D Overhead cost	25%	$25,000		$25,000	20%	$20,000
E Working capital required	45^	$12,329		$12,329	30^	$8,219
F Equipment capital required	8.00*	$12,500		$12,500	9.00*	$11,111
G True net profit	5%	$5,171	-5%	($4,829)	6%	$5,670

A *Assumed level of revenue growth*

B *Estimated profit after DIRECT JOB COSTS are subtracted from INVOICE:*

C *Line A times Line B*

D *Business expenses to run the office and pay non-production staff: The Overhead percentage (25% assumed here) times Line A.*

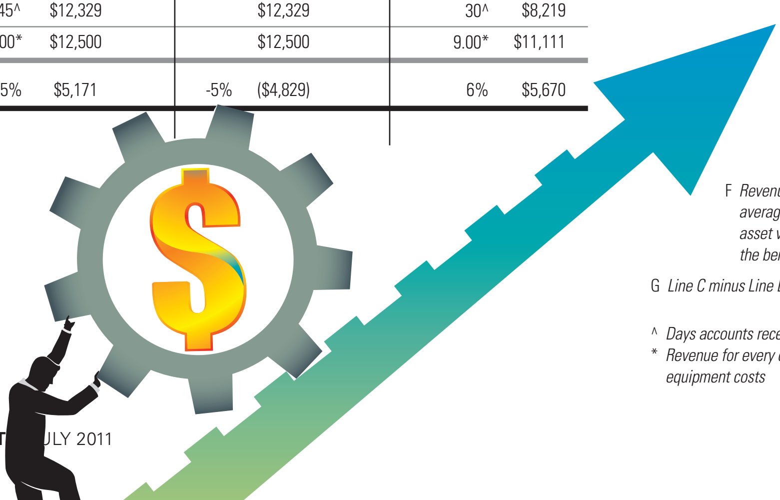
E *Amount of cash required to play bank for the customer: Line A divided by receivable turnover (365 days divided by the 45-day collection period)*

F *Revenue dollars divided by average balance sheet fixed asset value: Line A divided by the benchmark (8.00 here)*

G *Line C minus Line D, E, and F*

^ *Days accounts receivables*

* *Revenue for every dollar of annual capital equipment costs*



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