

Methods & Measurements to Shape Your Cash Flow

Understanding the three basic elements of the Cash Conversion Cycle and how to mold them to positively influence your cash flow.

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The goal of business operations is to make a profit. Nobody gets into business with a stated objective of losing money. There may be more reasons why you went into pharmacy in general, such as patient care, but at the end of the day, the goal of your business is to make a profit.

Cash flow is not the same as profitability, but the two concepts are related over the long term. For example, suppose your business generates a profit of \$0.25 on each \$1 of sales. This means you have to pay your vendors, employees, and general overhead \$0.75 of each \$1 that comes in the door. So, you keep \$0.25 of each \$1.

Now, suppose your business only generates a profit of \$0.10 per \$1 of sales. That means you pay out \$0.90 of each \$1 that comes in the door to other people. At the lower profit level you must sell 2 ½ times as much to generate the same level of take home cash! The difference in profit levels translates to you keeping more of the cash that comes into the business – hence greater cash flow. So, how do you increase profit levels?

Measuring Profitability

$$\begin{aligned} \text{Revenues (Sales)} - \text{Cost of Goods Sold (COGS)} &= \text{Gross Profit} \\ \text{Gross Profit} - \text{Operating Expenses (SG\&A)} &= \text{Net Profit (Take Home)} \end{aligned}$$

Fundamentally, net profit is everything you sell minus everything you pay out. Therefore, it's good to look for ways to increase how much you sell and decrease how much you pay out.

For example, training your staff to cross sell a related OTC with a given prescription is a quick and easy way to sell more, and direct marketing to doctors or the community can bring in new patients and increase sales. Any way you can find to sell more without increasing your current overhead base (i.e. building, fixtures, employees, etc.) is a good thing.

Correspondingly, look for ways to decrease your overhead base without negatively affecting sales. For example, work flow improvement can help you do the same or more with fewer people. Investing in energy efficient lighting, heating, or cooling can help lower operational expenses and increase profit. Charging a nominal delivery fee can help offset costs and increase profits. Again, anything you can reasonably do to increase sales or lower your expenses will help you keep more of the cash your business generates.

How to Influence the Elements of the Cash Conversion Cycle

The Cash Conversion Cycle (CCC) measures three basic elements of the balance sheet: Accounts Receivable (AR), Accounts Payable (AP), and Inventory. The balance sheet is like a sponge. Just as a sponge can soak up liquidity, so too can a balance sheet soak up cash (liquidity).

Higher AR or inventory balances soak up cash just like a small AP balance takes cash out of your bank right after you pay your suppliers.

Conversely, collecting receivables, leaning down your inventory, or choosing slower pay terms with your suppliers can increase your cash levels. Doing all three or a combination of them can have dramatic effects on cash balances.

A hypothetical example

Hypothetical Store:

- \$250,000/mo Rx Sales
(suppose 100% sold to third parties)
- \$200,000/mo Average COGS
- \$180,000 Average Inventory
- \$145,000 Average AP Balance
- \$260,000 Average AR Balance

The CCC would be calculated as follows (see other white paper for calculation details):

$$\begin{aligned} CCC &= \text{Inventory Conversion Period} + \text{Accounts Receivable Conversion Period} - \text{Accounts Payable Conversion Period} \\ CCC &= 27.4 + 31.6 - 22.1 = 36.9 \text{ days} \end{aligned}$$

In other words, our Hypothetical Store converts cash in the bank to cash in the bank in 36.9 days. Now, let's suppose we were able to reduce our average inventory by \$10,000 from \$180,000 to \$170,000. The CCC would be:

$$CCC = 25.8 + 31.6 - 22.1 = 35.3 \text{ days}$$

We increased our cash flow by 1.6 days or approximately \$13,150 (\$250,000/mo X 12 months ÷ 365 days X 1.6 days). The increase in our cash balance has an amplified effect over the reduction in inventory due to our profit margin or the difference between what we bought the product for versus how much we sell it for.

Now let's continue our example by also reducing our average accounts receivable balance from \$260,000 to \$230,000. The CCC would be:

$$CCC = 25.8 + 28.0 - 22.1 = 31.7 \text{ days}$$

We increased our cash flow by another 3.6 days or \$29,590. Now, let's finish our example Hypothetical Store by increasing our average accounts payable by \$25,000 from \$145,000 to \$170,000. The CCC would be:

$$CCC = 25.8 + 28.0 - 25.9 = 27.9 \text{ days}$$

We increased our cash flow by another 3.8 days or \$31,200.

The bottom line is that by making some simple adjustments to some balance sheet accounts we were able to reduce our CCC from 36.9 days to 27.9 days and thereby squeeze 9.0 days or approximately \$74,000 ($\$250,000/\text{mo} \times 12 \text{ month} \div 365 \text{ days} \times 9.0 \text{ days}$) of liquidity out of our balance sheet.