The *Critical* Factor

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In the petroleum industry, three combined items have a major impact on cash flow. These items are the trends in accounts receivable, inventory and accounts payable. When you combine the net effect of these three items into one sum, the result is what we at Meridian have named the critical factor.

You will likely not find the critical factor listed in any accounting text. It is our own invention. In a petroleum operation, however, the critical factor can cause cash swings in hundreds of thousands of dollars. For a typical 15 million-gallons-per-year fuel marketer, a typical one-month cash swing can be as much as a half-million dollars!

Ideally, from a cash flow perspective, you want the critical factor each month to be zero. A zero critical factor means you have used your trade suppliers to finance any increase in your receivables and inventory. This also means that you did not have to go out and borrow money from your banker, costing your company interest expense.

In additon, a zero critical factor also means that when your receivables and inventory decreased, you used that money to pay down your trade suppliers. As long as you did not make any early payments, this is an appropriate use of the cash generated. Otherwise, the spare cash could be used to pay down more expensive bank debt.

In fact, a positive critical factor is usually an indicator of good balance sheet management — reduction in receivables and/or reduction in inventory while keeping trade supplier amounts owing (a free source of cash) maximized.

In Meridian's Financial Mastery workshop at the Focus on Competitive Advantage event, to be held October 4-6, 2017, in Tucson, Arizona, I will offer a four-hour intensive discussion about getting to a zero critical factor. With focus on the drivers of profitability in the petroleum industry, this in-depth workshop is audience-led, and everyone from those new to the petroleum industry to experienced CPAs and chief financial officers will learn even more about how to get to a zero critical factor.

Let's analyze the basic, individual components of the critical factor.

Change in Accounts Receivable

An increase in accounts receivable in any time period costs cash. An increase can be due to two factors: more sales revenue and slower customer payments. A sales revenue increase can occur without a volume increase when fuel prices increase.

The easiest way to know whether a receivables increase is due to more revenue or slower customers is to calculate the average collection time. Divide your receivables balance at any point in time by an average day's credit sales using the last 30 days' sales receipts.

By tracking the results over time, you will see the trend in your customers' payment timing. An increasing number of days means customers are getting slower, if you have not lengthened your selling terms.

Next, compare the most recent result to your selling terms. How far beyond terms are your customers? If their payment timing is too long, take action to shorten the cycle. Your best bet is to be sure you have perfectly accurate invoices (obviously easier said than done) and then go to electronic funds transfer (EFT) collection terms.

Change in Inventory

Like receivables, any increase in inventory levels costs cash. Inventory increases may be necessary due to new sites, expanded product lines or opportunity buying to obtain discounts. Often, however, increased inventory is due to poor inventory management.

Like receivables, we use a calculation to determine if our inventory increase is due to a legitimate increase in business or mismanagement. By dividing our inventory balance by the average amount of cost of goods sold per day during the past 30 days, we can find how many days of supply on hand we are keeping in our present inventory.

An increase in days' supply on hand can be an indicator of inefficiency and waste in our system. Unless there are special buys or some other reason for a special temporary increase, management should work diligently to reduce the amount of inventory on hand. For a company that borrows money regularly on a working capital line of credit, each $100,000 in inventory costs about $10,000 a year in interest expense.

You may also wish to compare your inventory on hand with industry data.

Change in Accounts Payable

When it comes to accounts payable, any decrease within a financial period costs your company precious cash. In the good old days before EFT, accounts payable timing was easier to control. It's harder today, but not impossible. You can still have some impact through choice of vendors, terms and payment timing of non-EFT invoices.

First, though, it's advisable to check your payment timing. To do this, divide your accounts payable by your average

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daily cost of goods sold (the same figure from your inventory calculation). The result is the average time, in days, you pay your bills. For cash flow, more days is better as long as you do not exceed your vendors' terms and damage your credit rating!

To maximize the cash flow benefit of trade vendors, first, select vendors with longer, more generous terms. Whenever possible, negotiate more favorable terms. Second, never have staff pay bills before their due date. Finally, make sure that vendor credit limits are set high enough to take advantage of full terms.

In summary, for petroleum marketers, the critical factor is the best predictor of cash trends. If you pay close attention to your critical factor, you will see immediate improvement in your company's cash position and, subsequently, it's bottom-line profit.

Since 1991, Meridian has provided insight and services to over 3,500 petroleum marketers, growing and expanding their market share, while increasing their cash flow and profits. Being the leading petroleum valuation provider in the nation, Meridian is also trusted for buy-sell transactions. Meridian is hosting Focus On Competitive Advantage, a petroleum event designed for petroleum industry decision-makers, on October 4-6 in Tucson, Arizona. To find out what Meridian can do for you, visit www.askmeridian.com, or call us at 800.728.9005 for immediate assistance.

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family health insurance through his own employer, and who can easily afford to be added to her husband's insurance policy with the rest of her family. Unfortunately, the latter scenario is what the ACA requires!

Time will tell what Obamacare will look like under President Trump's administration, but I can only hope the end product will be a well-thought-out, surgically revised plan rather than a wholesale hatchet-wielding repeal that smacks of Washington D.C. politics. Some positive things about Obamacare should be retained in the Trump reform effort, but many parts need to be overhauled. At the end of the day, my sincere hope is that the Trump administration and Republican Congress will inject various reforms into the ACA that will produce a better law that addresses the health care crisis in our country in a fair and meaningful way. Who knows, if we're really lucky, the reform movement may include some medical and prescription drug cost controls, which I've always maintained are critical to achieving true health care reform.

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