Is Your Supplier Healthy?

Its P&L statement can contain vital clues to its well-being

By Tom Kosnik

Understanding the cost structure of a staffing supplier is critical to discovering the best and most stable staffing vendors in the market place. A common mistake from buyers is deciding whether to contract with a staffing supplier based on intuition or qualitative data rather than hard financial data. The profit and loss statement of a staffing vendor may be the best and most accurate source in determining the health of a staffing supplier. But it is generally a source that buyers do not ask about.

Examining the profit and loss statement of a staffing supplier should raise some intriguing questions. This information should enable you to make better decisions about your staffing vendors and gain a new insight from a staffing vendor's perspective regarding its cost structures.

P&L: A Primer

The basic structure of a profit and loss statement for a temporary staffing supplier would include the following:

- Revenue
- Cost of sales
- Gross margin
- Sales and recruiting expenses
- General and administrative expenses
- Pre-tax net income

Revenue Basis. There are many sources of a staffing firm's revenue. The main sources are temporary, temporary-to-direct, payrolling and direct hire.

Temporary revenue is generated from fulfilling temporary assignments at a client site. These temporaries vary greatly, from $10-an-hour light industrial workers to $75-an-hour IT consultants. This is the heart of a staffing firm's business and the kind of revenue that they typically desire the most.

Temp to Hire

Temporary-to-direct hire revenue is generated from assignments where the client brings a potential employee on through a staffing vendor for a certain time period prior to making an offer for full employment. It is the "try before you hire" scenario. Staffing suppliers generally do not like temp-to-direct revenue because it is a service in which they are consistently giving up a percentage of their inventory. Once a resource has gone to a client, the vendor has to find another resource to use for assignments.

Payrolling Proceeds

Payrolling revenue comes from clients that desire a staffing vendor to administrate the payroll function for a body of employees. Similar to traditional temporary staffing, the employer of record is the staffing vendor. For other than payroll specialist firms, this is typically a low priority, as it requires significant administrative work and the margins and profit are low.

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Direct Hire

Direct hire revenue is generated from finding full-time employees for clients. For most temporary staffing vendors, direct hire makes up a very small percentage of their overall revenue, and even though it can be more profitable than temporary staffing services, it generally causes more challenges than what it is worth.

Cost of sales. The cost of sales for a staffing supplier typically includes the temporaries' wages, the temporaries' city, state and federal income taxes, and workers' compensation insurance expense.

Temporary wages can range from $10-an-hour to $75-an-hour or more in some specialty cases or needs. While a buyer can have some say in the pay rate, the staffing firm is at the mercy of market demand and the bill rate the buyer is willing to pay. Staffing firms have other expenses, and buyers pay for those, too.

City, state and federal taxes, on the other hand, are set and straight forward. Whether the temporary employee is a person working for a company or its staffing vendor, these costs are fixed and must be paid, and economies of scale do not apply regardless of the amount of temporary services a buyer purchases. This fixed cost is in the invoice that a company receives from a staffing vendor. It is prudent to know what these expenses are in the invoice from a supplier when approaching the negotiation.

Workers Comp

Required by law, workers' compensation insurance rates can vary from staffing supplier to supplier. It is a good idea for a company to know its supplier's workers' compensation modification rate, as it can affect bill rates. Vendors that manage their workers' compensation claims well are in a position to keep this portion of their cost of sales reasonable.

A high modification rate may indicate mismanagement of workers' compensation claims and acceptance of risky business, although there are some cases where outside influences affect the workers' compensation expenses through no fault of the vendor. A low modification rate, meanwhile, can indicate healthy management of workers' compensation claims, which in turn is indicative of good management at the supplier's site.

Gross margin. Gross margin is revenue minus cost of sales (generally pay rate plus taxes and benefits) and is typically discussed as a percentage of revenue. General commercial staffing suppliers will often have an average gross margin ranging from 16 percent to 20 percent. Specialty staffing suppliers will have an average gross margin ranging from 20 percent to 30 percent or higher.

Gross margin is the central figure for a staffing supplier in terms of understanding the ratios of their expenses. More astute staffing suppliers manage their expenses as a percentage of their gross margin. In general, one third of the gross margin is allocated toward total sales and recruiting expense, one third toward general and administrative expense and one third toward pre-tax net income.

Finding out your supplier's average gross margin overall, as well as the average gross margin on your account, can be very revealing. An average gross margin on an account of 11 percent to 16 percent could point to risky business. A supplier would have to cut corners in order to offer services at such low margins. The supplier will say that it is doing "this" and "that" regarding your account. Chances are, "this" and "that" are not happening because there are not enough margin dollars coming through the account.

> Rather than using invoices to determine which vendors to use, base your decision on the vendor's P&L statements and overall health.

A supplier's gross margin also points to the concept of "pass through" dollars. If a supplier has an average gross margin of 20 percent, then 80 percent of the revenue is considered "pass through" dollars — it is going to pay temporary worker's wages, taxes and insurances. Many buyers decide whether to contract with a staffing supplier based on the invoices that they are seeing from a supplier. It would be far wiser to base such decisions on understanding the supplier's average gross margin on your account.

Sales and recruiting expenses. The sales and recruiting expense includes the wages, commissions, taxes, insurances and benefits for the entire sales and recruiting team of a supplier.

Knowing the details about this expense can be important for a buyer. This expense generally ranges from 30 percent to 40 percent of the gross margin. In general, a supplier whose sales and recruiting expense exceeds 30 percent to 40 percent of the gross margin either has underperforming employees or compensation plans or base salaries that are too rich or out of line with industry standards. Either case points back to inadequate management and poor decision-making at the management level. As a buyer, you want suppliers that are providing smart and effective management.

There are some cases, though, when the sales and recruiting expense exceeding 40 percent is not a bad sign. For example, when a supplier is growing at 30 percent to 100 percent, it is not uncommon to see the sales and recruiting expense high because the supplier is bringing on a lot of new employees to service new business and these new employees have not yet reached full production potential. Therefore, companies should inquire about the staffing vendor's rate of growth when evaluating sales and recruiting expenses against gross margin.

When evaluating your vendor's sales and recruiting expenses, it would be a good idea to understand the efficiency of your internal recruiting team. Whether done at a company's site or at its staffing vendor, the recruiting function still costs money. Going through a staffing vendor does not mitigate away the fulfillment expense, but it should reduce the expense for a buyer. Therefore, in order to determine if outsourcing the function makes sense, you should perform a quick exercise to determine the efficiency of your internal recruiting team. If a supplier cannot be more efficient than your internal recruiting team, then it does not make sense to outsource this function. In most cases, because a staffing firm's core competency is staffing, it generally can be more efficient than the buyer at recruiting.

General and administrative expense. General and administrative expenses, which generally are 20 percent to 30 percent of gross margin, include items such as rent, phones, business insurances, information technology, professional fees, travel and entertainment, marketing and job boards

General and administrative expenses that exceed 30 percent of the gross margin indicate poor expense management. On the other side, a supplier with such expenses that fall below 15 percent of the gross margin likely is cutting a lot of corners and paying internal employees below-industry standards.

The location of the vendor will affect the expenses as well. In urban settings, the general and administrative expenses will be closer to that 30 percent of the gross margin and in rural settings the general and administrative expense will be closer to 20 percent.

Pre-tax net income. The net income, the staffing supplier's profit, ranges from 3 percent to 10 percent of revenue. Wiser staffing suppliers will attempt to drop 30 percent of the gross margin toward net income. A staffing supplier whose average gross margin is 18 percent should have a pre-tax net income of 5 percent or 6 percent of revenue.

If a staffing supplier has $50 million in annual revenue with a 1 percent net income, something is wrong. It can be a high-risk or poorly managed vendor.

While the owner of the business could be legitimately draining the company of profits through distributions, this is something you can ask about.

The owner could be trying to show as little profit as possible in order to reduce tax liabilities. The owner could be using net income dollars to fund account receivables or even acquisitions of other staffing firms. All such cases justify a below-average net income percentage.

On the other hand, the business could have a below-average net income because the business is paying for the owner's vacation home. The owner of the business may think, "Why should a buyer care what I do with the net income of my business? The money is mine. I worked for it and I will do with it what I like." The point is, well-managed staffing suppliers will be getting good advice from accountants and lawyers and will be making smart cash management decisions. Poor cash management will generally mean a higher-risk supplier.

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Working the Numbers

Most staffing vendors will be hesitant to hand over or answer questions about their profit and loss statements. In order not to alienate your staffing suppliers, keep these things in mind.

To start, pull together a team from your HR, purchasing and the finance departments. Determine the specific outcomes you are attempting to gain by accessing such information from your vendors. Develop the framework and/or program, how it is going to be conducted, evaluated and what you are going to do with the results. How does it all support your company's staffing strategy?

Once your program has been defined and developed, assign one person in your organization to request and evaluate the financial information. (You may assign this person an assistant, depending on how many vendors you will be evaluating.) This person will follow the program and be consistent with every staffing supplier. Having favorites or bending the rules for certain staffing suppliers will put the program as risk.

After all of the data have been collected and analyzed, do something with the information and program. Wean the staffing suppliers off your vendors list you deem as high-risk and go find staffing suppliers that fit a partnering profile. Again, the point of the exercise is to rid your company of high-risk staffing vendors and surround your company with well-managed staffing suppliers that will meet your human capital acquisition needs efficiently and effectively.

Finally, evaluate the program and the specific work regularly. Do not be afraid to bring in some staffing vendors at this stage. Don't be afraid to use an outside, objective firm to gain feedback from staffing suppliers about a new program in which you are requesting financial information from your suppliers. In the end you want to avoid alienating your company from the best staffing firms in the marketplace and make these suppliers true partners.

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