

# Financial Management

Understanding financial statements is one of the essential keys to business success. Financial statements are used by Owners to keep score on the business, to know and understand whether the business is succeeding, to know whether a profit is being made, and to understand why and how this occurs.

## **Cash Accounting Method**

In the Cash Accounting method, all transactions are recorded in your books only when a check or cash is actually received (“Receipts”) or when a check or cash is actually sent (“Disbursements”) from or to third parties.

## **Accrual Accounting Method**

In Accrual accounting methods transactions are recorded when they become due and payable (a sale is recorded when an invoice is sent or an obligation of the business is recognized as due and payable, and an expense or asset acquisition is recorded when an invoice is received or an obligation to pay is recognized as due and payable).

The Accrual Accounting Method is the most useful method for reflecting the true condition and results of a landscape contracting business. It is the only accounting method, which assures that Revenues and the costs to produce them are matched in the same accounting period. Cash Basis Accounting is typically only used by smaller businesses, frequently is used for income tax reporting, and is typically used by retail nurseries.

## **THE BALANCE SHEET**

The Balance Sheet depicts the financial status of your business at a single point of time, typically the end of a fiscal year, fiscal quarter, or month. It is a tally of what the business owns (Assets), what it owes (Liabilities), and the net value of the owner’s interest in the business (Owner’s Equity).

It is important to remember the basic Balance Sheet Equation, which is:

$$\text{Assets} - \text{Liabilities} = \text{Owner's Equity}$$

A typical Balance Sheet format for a landscape Design Build contractor is presented at the back of this Chapter. Account titles for the balance Sheet are as follows.

### **Current Assets**

Represent those assets, which are largely expected to turnover into cash within the next 12-month period. A separation is typically made between near-cash items and physical items such as inventories of materials and supplies for jobs, which typically have a longer turnover period.

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## Fixed Assets

Represent assets which are needed to support the operations of the Company. This includes land, buildings, vehicles and field equipment, office furniture and equipment, as well as improvements to land and buildings, which are owned by the company. Certain types of Leased Equipment are sometimes capitalized to be reflected equivalent to owned equipment.) Fixed assets are written off to depreciation expense over their expected useful life to assure that the cost of this equipment is reflected as a portion of the operating costs and expenses of the company. Amounts so written off are accumulated as “depreciation” on the Balance Sheet and netted against the original acquisition costs of the depreciable assets to identify the net, un-expensed value of the assets.

## Current Liabilities

Amounts due and payable to vendors, banks, employees, and tax agencies and others that are payable within the scope of the next 12 month period. Typically, principal portions of long term Notes Payable that are to be paid within the forthcoming 12 month period are added under Current Liabilities and shown as a subtraction from Note balances under Long Term Liabilities.

## Long Term Liabilities

Term Notes which are payable in periods extending beyond the current year are included in this section. This would include term financing with the bank or others to support longer range assets such as buildings, improvements and equipment which are themselves expected to support operations over an extended period of years.

## Stockholder’s Equity

Mathematically speaking, Stockholder Equity is the net difference between Total Net Assets Owned and the Total Liabilities for Payables and Debts of the company.

This is the Balance Sheet Formula of: **Assets -Liabilities = Equity**.

The Balance Sheet is a key financial document representing the financial strength (or weakness) and position of the business at the end of each fiscal accounting period. Changes in these numbers and relationships should be of key interest to managers to ensure they understand the meaning and relationships of the numbers and to monitor trends in the business over successive periods of time.

The Balance Sheet is a key financial statement of interest to outsiders with an interest in your business such as investors, bankers, bonding companies and sometimes even customers, all of whom wish to assure themselves of your financial strength and stability in support of their relationships with you.

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ASSETS	Explanation
<b><u>Current Assets:</u></b>	
Cash on Hand & Bank	<i>Cash in the Bank or available for deposit</i>
Short Term Investments	<i>Money Market, CD's, etc.</i>
Accounts Receivable - Trade	<i>Billings for Jobs, Materials and Services</i>
Less: Allowance for Doubtful Accounts	<i>Receivables you are likely not to collect</i>
Notes Receivable - Short Term	<i>Any other near term notes due to you</i>
Inventories	<i>Plant Material Inventoried (Not assigned to jobs)</i>
Work In Process Inventory	<i>Work Completed or Purchased but not billed</i>
Inventories - Materials & Supplies	<i>Materials, Supplies, etc. on hand</i>
Prepaid Assets	<i>Prepaid Insurance, etc.</i>
<b>Total Current Assets</b>	
<b><u>Fixed Assets:</u></b>	
Land / Buildings	<i>Original Cost of land owned by the business</i>
Trucks, Trailers, Autos	<i>Original Cost of Licensed rolling stock</i>
Operating Equipment	<i>Original Cost of Owned Equipment</i>
Furniture & Fixtures	<i>Original Cost of Furniture, Computers, Shelving, etc.</i>
<b>Total Fixed Assets @ Cost</b>	
Depreciation - Buildings	<i>Amounts Written off to Expense since acquisition</i>
Depreciation - Trucks, Trailers, Autos	<i>Amounts Written off to Expense since acquisition</i>
Depreciation - Operating Equipment	<i>Amounts Written off to Expense since acquisition</i>
Depreciation - Furniture & Fixtures	<i>Amounts Written off to Expense since acquisition</i>
<b>Total Depreciation</b>	
<b>Net Fixed Assets</b>	<i>Total Fixed Assets minus Depreciation charges</i>
<b><u>Other Assets:</u></b>	
Long Term Notes Receivable	<i>Notes receivable beyond 1 year</i>
Cash Value Life Insurance	<i>Cash Value of Officer's Life Ins. owned by the business</i>
Less: Current Portion Long Term Notes	<i>Principal Portion of LT Notes due in next 12 months</i>
<b>Total Other Assets (Net)</b>	
<b>TOTAL ASSETS</b>	<i>Total of Current, Net Fixed, and Other Assets</i>

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LIABILITIES & EQUITY	Explanation
<b><u>Current Liabilities:</u></b>	
Accounts Payable - Trade	<i>Accounts Payable to Vendors</i>
Accounts Payable - Other	<i>Other current accounts payable</i>
Accounts Payable - Retention	<i>Retentions withheld from Subcontractors</i>
Notes Payable - Bank	<i>Usually your Bank Line of Credit balance</i>
Current Portion of Long Term Notes	<i>Principal Portion of Term Notes due in next 12 months</i>
Current Portion of Capital Leases	<i>Principal Portion of Cap. Leases due in next 12 mos.</i>
Accrued Payroll	<i>Payrolls earned but not yet paid out</i>
Accrued Payroll Taxes	<i>Payroll Taxes accrued but not yet paid</i>
Accrued Benefits Payable	<i>Benefits earned but not yet paid</i>
Accrued State & Local Taxes	<i>Taxes Accrued but not yet paid</i>
<b>Total Current Liabilities</b>	
<b><u>Long Term Liabilities</u></b>	
Notes Payable - Banks	<i>Term Borrowings from bank</i>
Notes Payable - Equipment Loans	<i>Equipment Loan balances</i>
Notes Payable - Mortgages	<i>Mortgage balances if any</i>
Notes Payable - Stockholders	<i>Term loans from stockholders or private loans</i>
Notes Payable - Other	<i>Any other Long Term Notes</i>
Capital Leases Payable	<i>Unexpensed balances on Capital Equipment leases</i>
Less: Current Portions LT Debt	<i>Principal portions of all LTD due next 12 mos.</i>
<b>Net Long Term Liabilities</b>	
<b>TOTAL LIABILITIES</b>	
<b><u>Stockholder's Equity</u></b>	
Capital Stock	<i>Original Capital from owners</i>
Paid In Capital	<i>Subsequent Capital contributed from owners</i>
Treasury Stock	<i>Value of stock shares repurchased from owners</i>
Retained Earnings Beginning	<i>Earnings retained as of end of previous fiscal year</i>
Net Profit (Loss) This Year to Date	<i>Net profit (loss) from the Income Statement</i>
Less Dividends Paid Year to Date	<i>Show dividends paid from current earnings</i>
<b>TOTAL STOCKHOLDER EQUITY</b>	
<b>TOTAL LIABILITIES &amp; EQUITY</b>	<i>Total of Liabilities plus Equity</i>

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ASSETS		
<b><u>Current Assets:</u></b>		
Cash on Hand & Bank	\$ 40,235	
Short Term Investments	\$ 19,150	
Accounts Receivable - Trade	\$ 187,269	
Accounts Receivable - Other	\$ 6,800	
Less: Allowance for Doubtful Accounts	\$ (5,000)	
Notes Receivable - Short Term	<u>\$ -</u>	
<b>Total Current Receivables</b>		<b>\$ 248,454</b>
Inventories - Green Goods	\$ 17,500	
Inventories - Hard Goods	\$ 6,200	
Work In Process Inventory	\$ 3,651	
Inventories - Materials & Supplies	<u>\$ 2,700</u>	
<b>Total Inventories</b>		<b>\$ 30,051</b>
Prepaid Assets		<u>\$ 12,000</u>
<b>Total Current Assets</b>		<b>\$ 290,505</b>
 <b><u>Fixed Assets:</u></b>		
Buildings	\$ 80,000	
Improvements	\$ 15,000	
Trucks, Trailers, Autos	\$ 106,300	
Operating Equipment	\$ 131,100	
Furniture & Fixtures	<u>\$ 52,600</u>	
<b>Total Fixed Assets @ Cost</b>		<b>\$ 385,000</b>
Depreciation - Buildings	\$ (28,000)	
Depreciation - Improvements	\$ (3,000)	
Depreciation - Trucks, Trailers, Autos	\$ (40,303)	
Depreciation - Operating Equipment	\$ (55,062)	
Depreciation - Furniture & Fixtures	<u>\$ (17,890)</u>	
<b>Total Depreciation</b>		<b><u>\$ (144,255)</u></b>
<b>Net Fixed Assets</b>		<b>\$ 240,745</b>
 <b><u>Other Assets:</u></b>		
Long Term Notes Receivable	\$ -	
Cash Value Life Insurance	\$ 3,750	
Less: Current Portion Long Term Notes	<u>\$ -</u>	
<b>Total Other Assets (Net)</b>		<b>\$ 3,750</b>
 <b>TOTAL ASSETS</b>		 <b>\$ 535,000</b>

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## LIABILITIES & EQUITY

### Current Liabilities:

Accounts Payable - Trade	\$ 40,370	
Accounts Payable - Other	\$ 3,500	
Accounts Payable - Retention	\$ -	
Notes Payable - Bank	\$ 31,305	
Current Portion of Long Term Notes	\$ 16,845	
Accrued Payroll	\$ 18,500	
Accrued Payroll Taxes	\$ 12,010	
Accrued Benefits Payable	\$ 3,000	
Accrued State & Local Taxes	<u>\$ 12,500</u>	
<b>Total Current Liabilities</b>		<b>\$ 138,030</b>

### Long Term Liabilities

Notes Payable - Banks	\$ 103,690	
Notes Payable - Equipment Loans	\$ 45,300	
Notes Payable - Stockholders	\$ -	
Notes Payable - Other	\$ -	
Less: Current Portions LT Debt	<u>\$ (16,845)</u>	
<b>Net Long Term Liabilities</b>		<b>\$ 132,145</b>

**TOTAL LIABILITIES** **\$ 270,175**

### Stockholder's Equity

Capital Stock	\$ 25,000	
Paid In Capital	\$ 10,000	
Treasury Stock	\$ -	
Retained Earnings Beginning	\$ 178,965	
Net Profit (Loss) This Year to Date	\$ 50,900	
Less Dividends Paid Year to Date	<u>\$ -</u>	
<b>TOTAL STOCKHOLDER EQUITY</b>		<b>\$ 264,865</b>

**TOTAL LIABILITIES & EQUITY** **\$ 535,040**

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## **THE PROFIT AND LOSS STATEMENT (THE INCOME STATEMENT)**

The Income Statement depicts the financial operations of your business over a given fiscal period such as a month, quarter, or year and the amount of profit (or loss) earned during each period. This is a key statement for monitoring operations and financial relationships as they occur and should be produced on a regular and routine basis, usually at the end of each month. A typical Income Statement for a landscape Design Build contractor is shown at the back of this chapter. This chart of accounts depicted by the Profit & Loss Statement is a standard format recommended by the industry.

The following chart titles describe this chart of accounts. For analysis purposes all expenses are shown in their percentage relationship to total sales as a convenience in monitoring progress, trends and financial relationships.

### **Sales Revenue:**

Sales Income totals are maintained and reflected for each critical service or product line of the business. It is a smart manager who also records all subsequent costs relevant to each product or service line in departmentalized accounting in order to determine the profitability of each line. Subsequent discussion of costs and expenses is consolidated as a single line item for purposes of this discussion.

### **Direct Costs:**

Direct costs are those, which may be directly associated and accounted for by each job or billable service, which the company produces. These are the items, which are directly estimated in bidding for jobs to which markups or margins will be applied to determine final pricing of the work. These costs can and should be accounted for by department as well as for each job produced. As shown, these costs include all Direct Labor, Payroll Taxes, Materials, Rentals, and Sub-Contracts estimated into jobs produced and are considered to vary directly with the volume of work produced

### **Gross Margin:**

This term is applied to the net difference between Sales Revenue and the Direct Costs for each job and for each accounting period. Monitoring of this number and the percentage relationship to Sales Revenue is highly critical in determining if the bid profitability of completed work is being achieved.

### **Indirect Overhead Expense:**

Certain costs and expenses, while they may vary with the amount of work being produced, do so indirectly and are not normally identifiable to specific jobs or lines of work. They are typically shown as Indirect Costs and should at least be identifiable to each department producing billable work. They represent the costs of business necessary to directly support the operations of the business and are regarded as operating expenses. Specific types of costs are reflected and explained in Exhibits C and D.

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## **Contribution Margin:**

This number represents the result of subtracting total Direct and Indirect costs from Sales Revenue for each department and product or service line being tracked. In total for the company it represents the remaining money available to cover all General Overheads and Net Profit requirements of your business. Monitoring of this number and its percentage relationship to Sales Revenue is important to tracking profitability and trends for each department of the company.

## **General & Administrative Overhead Expense:**

Those costs generally associated with the overall support and operation of the business that, over broad ranges, are not regarded as variable with respect to the level of current operations are included in this section of the Income Statement. These costs may be tracked to certain departments of the company but with difficulty and accounting costs, which may or may not be warranted. Typically they would be “allocated” to departments in part or in total based on certain other variables such as Sales, Total Direct + Indirect Cost, Labor Hours, Equipment Investment or other allocation vehicles.

## **Operating Profit:**

Operating Profit is the result of subtracting all Operating Costs from Total Sales Revenue. It reflects the profitability of the operations of the business and should be monitored on an on-going basis.

## **Other Income & Expense:**

Typically, this section reflects miscellaneous income items. That are not an integral part of the operations or profit strategies of the business. Frequently, Interest Expense (shown here) may be shown in the General & Administrative Expense section of the Income Statement if it is regarded as a normal expense related directly to the operating situation.

## **Net Profit Before Taxes:**

This number is regarded as the proverbial “bottom line” for measurement of your company’s profitability. The absolute number as well as its’ percentage relationship to Sales Revenue is one of the most closely watched numbers in business.

## **Net Profit After Taxes:**

Since Federal Income Tax is only determined on the basis of Reported profits it is typically in the last section of the Income Statement. It can vary each year depending on prior reporting of results and may or may not be relevant to a given year. It is shown here to demonstrate the reporting relationship shown on the Balance Sheet as it is the number reported as this year’s contribution to the Retained Earnings of the business.

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CHART OF ACCOUNTS	Explanation
<b>SALES REVENUE:</b>	
<b>Design Build Sales</b>	<i>Design Build Installation Sales</i>
<b>Total Sales Revenue</b>	<i>Total Sales Revenues</i>
<b>DIRECT JOB COSTS:</b>	
<b>Direct Labor</b>	<i>Direct Labor Applied to Jobs</i>
<b>Direct Labor Payroll Taxes</b>	<i>Payroll Taxes (FICA, Unemployment)</i>
<b>Materials - Plants</b>	<i>Plants Applied to Jobs</i>
<b>Materials - Other</b>	<i>Hard Materials, Soils, Rock, etc.</i>
<b>Job Equipment Rentals</b>	<i>Equipment Rentals included in Bids</i>
<b>Subcontractors</b>	<i>Subcontractor Costs Included in Jobs</i>
<b>Other</b>	<i>Other Direct Costs included in Bid costs</i>
<b>Total Direct Job Costs</b>	<i>Total Direct Job Costs</i>
<b>GROSS MARGIN</b>	<i>Total Sales Revenue Less Direct Job Costs</i>
<b>INDIRECT OVERHEAD:</b>	
<b>Indirect Labor</b>	<i>Supervisory &amp; Other Non-Job related Labor</i>
<b>Indirect Labor Payroll Taxes</b>	<i>Payroll Taxes on Indirect Labor Payroll</i>
<b>Replacement Expenses</b>	<i>Cost of Replacements on Jobs</i>
<b>Small Tools &amp; Supplies</b>	<i>Small Tools, Shop Supplies, etc.</i>
<b>Fuel &amp; Oil Expense</b>	<i>Gas, Grease, Oils to support operations</i>
<b>Equipment Maint. &amp; Repair Expense</b>	<i>Repairs, Tires, Parts, Lubes, etc.</i>
<b>Equipment/Vehicle Insurance</b>	<i>Insurance on all field &amp; operations Equipment</i>
<b>Operating Facility Lease/Rent</b>	<i>Cost of Shop &amp; Yard Rent/Leases</i>
<b>Depreciation (Vehicle,Equip.,Facility)</b>	<i>Depreciation on Equipment &amp; Facility</i>
<b>Employee Training</b>	<i>Field Employee training, seminars, books, etc.</i>
<b>Uniforms</b>	<i>Employee uniform expenses</i>
<b>Other</b>	<i>Other &amp; Misc. Operating Expenses</i>
<b>Total Indirect Overhead</b>	<i>Total of Indirect Expenses to Support Operations</i>
<b>CONTRIBUTION MARGIN</b>	<i>Gross Margin Less Indirect Expenses</i>

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## **GENERAL & ADMINISTRATIVE OV'HD:**

<b>Advertising &amp; Promotion</b>	<i>Advertising, Brochures, etc. to promote sales</i>
<b>Salaries - Owners</b>	<i>Total Owner's Compensation</i>
<b>Salaries - Sales &amp; Commissions</b>	<i>Selling Salaries &amp; Commissions, Bonuses, etc.</i>
<b>Salaries - Administrative</b>	<i>Office Staff Salaries</i>
<b>Payroll Taxes on Salaries</b>	<i>Payroll Taxes on Salaries, Commissions, Bonuses</i>
<b>Payroll Benefits</b>	<i>Pension, 401k, contributions</i>
<b>Insurance - Hospital &amp; Life</b>	<i>All Medical, Life, Disability Income Insurance</i>
<b>Insurance - General Liability</b>	<i>General Liability Insurance Policy Premiums</i>
<b>Insurance - Worker's Comp.</b>	<i>Workers Comp. &amp; Industrial Insurance Premiums</i>
<b>Insurance - Facility</b>	<i>Insurance on Office, Shop, Facilities</i>
<b>Office Expense</b>	<i>Printing, Copy, Paper, Forms, Maint. Etc.</i>
<b>Postage &amp; Mailing</b>	<i>Postage Stamps, FedEx, UPS charges</i>
<b>Communications Expense</b>	<i>Telephone, Cell Phone, Radio, Fax, DSL etc.</i>
<b>Utilities Expense</b>	<i>Power, Water, Sewer utilities charges</i>
<b>Travel &amp; Entertainment</b>	<i>Travel for meetings, Conventions, General</i>
<b>Education Expense</b>	<i>Cost of Seminars, Conventions, Training, Etc.</i>
<b>Dues &amp; Subscriptions</b>	<i>Association Dues, Papers, Magazines</i>
<b>Taxes - Property related</b>	<i>Real Estate and Facility Based Public Taxes</i>
<b>Taxes - Sales Related</b>	<i>Revenue Taxes based on Sales (Not Sales Tax)</i>
<b>Other &amp; Misc. Expense</b>	<i>Other Miscellaneous Expenses</i>
<b>Total Gen'l &amp; Admin Expense</b>	<i>Total of G &amp; A Overhead Expenses</i>

## **OPERATING PROFIT**

*Contribution Margin Less G & A Expenses*

## **OTHER INCOME & EXPENSE:**

<b>Gain(Loss) on Asset Sales</b>	<i>Money Gained or Lost over book values</i>
<b>Interest Income</b>	<i>Interest earned on investments, A/R's etc.</i>
<b>Interest Expense</b>	<i>Interest Paid on Loans, Notes, A/P's etc.</i>

## **NET PROFIT BEFORE TAXES**

*Operating Profit Less Other Income & Expense*

## **Federal Income Taxes**

*Accrued and/or Paid Federal Income Tax*

## **NET PROFIT AFTER TAXES**

*Net Earnings Gain or Loss this period (to Equity)*

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## SALES REVENUE:

<b>Design Build Sales</b>	\$ 1,080,000	72.0%
<b>Maintenance</b>	\$ 360,000	24.0%
<b>Irrigation</b>	<u>\$ 60,000</u>	4.0%
<b>Total Sales Revenue</b>	<b>\$ 1,500,000</b>	100.0%

## DIRECT JOB COSTS:

<b>Direct Labor</b>	\$ 340,500	22.7%
<b>Direct Labor Payroll Taxes</b>	\$ 34,500	2.3%
<b>Materials - Plants</b>	\$ 223,200	14.9%
<b>Materials - Other</b>	\$ 148,800	9.9%
<b>Job Equipment Rentals</b>	\$ 3,500	0.2%
<b>Subcontractors</b>	\$ 93,000	6.2%
<b>Other</b>	<u>\$ 2,500</u>	0.2%
<b>Total Direct Job Costs</b>	<b>\$ 846,000</b>	56.4%

## GROSS MARGIN

**\$ 654,000** 43.6%

## INDIRECT OVERHEAD:

<b>Indirect Labor</b>	\$ 36,000	2.4%
<b>Indirect Labor Payroll Taxes</b>	\$ 3,000	0.2%
<b>Replacement Expenses</b>	\$ -	0.0%
<b>Small Tools &amp; Supplies</b>	\$ 12,000	0.8%
<b>Fuel &amp; Oil Expense</b>	\$ 25,500	1.7%
<b>Equipment Maint. &amp; Repair Expense</b>	\$ 31,500	2.1%
<b>Equipment/Vehicle Insurance</b>	\$ 10,500	0.7%
<b>Operating Facility Lease/Rent</b>	\$ 22,500	1.5%
<b>Depreciation (Vehicle,Equip.,Facility)</b>	\$ 45,000	3.0%
<b>Employee Training</b>	\$ 3,000	0.2%
<b>Uniforms</b>	\$ 4,500	0.3%
<b>Other</b>	<u>\$ 1,500</u>	0.1%
<b>Total Indirect Overhead</b>	<b>\$ 195,000</b>	13.0%

## CONTRIBUTION MARGIN

**\$ 459,000** 30.6%

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## GENERAL & ADMINISTRATIVE OV'HD:

Advertising & Promotion	\$ 19,500	1.3%
Salaries - Owners	\$ 88,500	5.9%
Salaries - Sales & Commissions	\$ 61,500	4.1%
Salaries - Administrative	\$ 57,000	3.8%
Payroll Taxes on Salaries	\$ 19,500	1.3%
Payroll Benefits	\$ 12,500	0.8%
Insurance - Hospital & Life	\$ 16,500	1.1%
Insurance - General Liability	\$ 9,000	0.6%
Insurance - Worker's Comp.	\$ 18,500	1.2%
Insurance - Facility	\$ 3,000	0.2%
Office Expense/Rent/Dep't	\$ 30,000	2.0%
Postage & Mailing	\$ 1,500	0.1%
Communications Expense	\$ 13,500	0.9%
Utilities Expense	\$ 6,000	0.4%
Travel & Entertainment	\$ 6,000	0.4%
Education Expense	\$ 7,500	0.5%
Dues & Subscriptions	\$ 3,000	0.2%
Taxes - Property related	\$ 1,500	0.1%
Taxes - Sales Related	\$ 1,500	0.1%
Other & Misc. Expense	<u>\$ 6,000</u>	0.4%
<b>Total Gen'l &amp; Admin Expense</b>	<b>\$ 382,000</b>	<b>25.5%</b>
<b>OPERATING PROFIT</b>	<b>\$ 77,000</b>	<b>5.1%</b>
<b>OTHER INCOME &amp; EXPENSE:</b>		
(Gain)Loss on Asset Sales	\$ (3,600)	-0.2%
Interest Income	\$ (1,000)	-0.1%
Interest Expense	\$ 15,700	1.0%
Other Income & Expense	<u>\$ -</u>	
<b>Total Other Income &amp; Expense</b>	<b>\$ 11,100</b>	<b>0.7%</b>
<b>NET PROFIT BEFORE TAXES</b>	<b>\$ 65,900</b>	<b>4.4%</b>
Federal Income Taxes	\$ 15,000	1.0%
<b>NET PROFIT AFTER TAXES</b>	<b>\$ 50,900</b>	<b>3.4%</b>

# ANALYZING THE INFORMATION

Once you have a good understanding of the basic financial statements and their formats it is important to analyze the information for a true understanding of what they mean.

Ratio Analysis is a meaningful process that gives you tools for enhancing profitability. Ratios describe important financial relationships and are an important tool for setting goals. They enable you to compare yourself to your industry standards and they provide a track record to monitor trends in your own company over time.

Suppliers, bankers and outside creditors have a wide range of financial ratios available to them for analyzing your financial performance. Banks use a service called Robert Morris & Associates which reports financial ratios on a very broad spectrum of industries and companies. Landscape contracting companies can also be analyzed in detail. An important source of industry ratios is published "Operating Cost Study", a joint publication of the Associated Landscape Contractors of America and the American Nursery & Landscape Association. A copy of this study should be an important part of your financial tool kit.

Calculation of ratios breaks down into four types of analysis based on the source:

- Balance Sheet Ratios (Computed solely from the Balance Sheet)
- Income Statement Ratios (Computed solely from the P & L Statement)
- Understatement Ratios (Use data from both the P&L & the Balance Sheet)
- Interface Ratios (Uses data from your financial statements and internal data reports on production such as Total Staffing, Production Hours, Average Job Size, etc.)

## **Balance Sheet Ratios**

**NOTE:** For comparative purposes columns have been included showing the median ratio for Design Build Contractors as reported in the 2001 Operating Cost Study. A column called "High Profit D/B Contractors" shows data collected from the top 25% of contractors based on reported Return on Assets.

### **Current Ratio**

*(Current Assets divided by Current Liabilities)*

A principal measure of liquidity the current ratio gives an indication of your ability in the short term to meet bills as they come due. Banks typically will look for a minimum relationship of 1:1 or higher or seek an explanation.

### **Quick Ratio**

*(Liquid Current Assets divided by Current Liabilities)*

Compares only very liquid Current Assets to Current Liabilities and includes Cash, Marketable Securities, and Current (under 60 days) Accounts Receivable This ratio, frequently used by Surety Bond companies is an indication of how likely quick recovery could be accomplished should you default on a surety bond.

### **Debt to Equity Ratio**

***(Total Liabilities Assets divided by Total Equity)***

The Debt to Equity ratio is an indicator of the relationship between the money the owners of the company have contributed or retained in the company and the degree to which they rely on outside financing for funding. Too low a ratio could indicate that the company has unused growth potential and too high a ratio can be an indicator of previous poor profitability or a growth rate faster than can be financed prudently from internal resources. Banks and Bonding Companies will typically not shy from ratios of 2:1 or higher if a company is managed by knowledgeable people who present a reasonable plan.

**Leverage Ratio**

***(Total Assets divided by Total Equity)***

Leverage is an indication of the degree to which the owners have been able to grow the company based on the money they have retained in the business. Frequently this ratio is useful when forecasting growth potential for the company as it measures the degree to which new asset additions can be supported by earnings.

**Asset Newness Ratio**

***(Net Fixed Assets divided Gross Fixed Assets)***

The Asset Newness Ratio is a good comparative ratio for indicating how well the company is staying up to date with equipment. A low ratio indicates that equipment is being used to extended lives and that large amounts of new equipment financing may be required in the future. A high ratio would possibly indicate equipment is newer and more up-to-date or, that the company may have over-equipped itself.

**Example**

Ratio Name	Numerator	Denominator	Actual Ratio	Average D/B Contractor	High Profit D/B Contractor
Current Ratio	\$ 290,505	\$ 138,030	2.1	2.2	4.7
Quick Ratio	\$ 248,454	\$ 138,030	1.8	1.8	4.0
Debt to Equity	\$ 270,175	\$ 239,415	1.1	1.0	0.6
Leverage	\$ 535,000	\$ 239,415	2.2	2.3	1.7
Asset Newness	\$ 240,745	\$ 385,000	0.63	0.45	N/A

**Income Statement Ratios**

**Gross Margin Percent**

***(Gross Profit divided by Sales)***

Gross Margin represents the money the company earns after direct costs are covered. It is a general indicator of production efficiency and estimating / pricing accuracy. This ratio should be monitored monthly. Gross margin percent divided into total overhead is the way to determine the Breakeven Point.

**Net Profit Margin**

***(Net Profit divided by Sales)***

Net Profit Margin (“bottom line”) is the most often used measure of profitability. It is the summary of the company’s ability to produce profitable sales, manage gross margins and control operating costs. A brief look at comparisons between D/B Contractors, the industry average and the high profit contractors:

<u>Income Statement</u>	<u>D/B</u>	<u>Average</u>	<u>High Prof.</u>
Net Total Sales	100.0%	100.0%	100.0%
Total Direct Job Cost	56.4%	56.4%	52.7%
Gross Margin	43.6%	43.6%	47.3%
Total Indirect Ovhd	13.0%	13.0%	10.6%
Contribution Margin	30.6%	30.6%	40.3%
Gen’l & Admin Ovhd	25.5%	25.4%	19.8%
Other Income & Expense	<u>.7%</u>	<u>1.1%</u>	<u>.5%</u>
<b>Net Profit Before Taxes</b>	<b>4.4%</b>	<b>4.3%</b>	<b>16.0%</b>

### Overhead to Sales and Overhead to Direct Cost

*(Overhead divided by Sales AND Overhead divided by Direct Cost)*

These ratios both provide an indication and comparison of the company’s ability to support sales and production volume from overheads. Here, D/B is doing an average job in the industry but might be considered to have high overheads compared to the way “high profit” contractors are able to operate.

<b>Ratio Name</b>	<b>Numerator</b>	<b>Denominator</b>	<b>Actual Ratio</b>	<b>Average D/B Contractor</b>	<b>High Profit D/B Contractor</b>
<b>Gross Margin</b>	\$ 654,000	\$ 1,500,000	43.6%	43.6%	47.3%
<b>Net Profit Percent</b>	\$ 65,900	\$ 1,500,000	4.4%	4.3%	16.0%
<b>Overhead/Sales</b>	\$ 577,000	\$ 1,500,000	0.38	0.38	0.31
Overhead/Direct	\$ 577,000	\$ 846,000	0.68	0.68	0.59

## **Interstatement Ratios**

### **Return on Assets**

*(Net Profit divided by Total Assets)*

This is the critical measure of true profitability. It compares net profits to a asset investment indicating effective employment of all assets. Successful companies achieve a minimum 20% ratio.

### **Return on Equity**

*(Net Profit divided by Total Equity)*

This is owner return on investment ratio. It is heavily influenced by the Debt to Equity ratio. WARNING: A high Debt / Equity ratio may indicate that owners have minimized their equity investment and maximized use of debt. In this case LOW Net Profit margins might falsely indicate high Return on Equity ratios. Successful companies achieve a minimum 30% ratio. Due to the high risks involved in contracting, this ratio should be substantially above what can be earned on alternative investment opportunities at lower risk.

### **Asset Turnover and Sales to Fixed Assets**

*(Total Assets divided by Sales AND Net Fixed Assets divided by Sales)*

Both these ratios are indicators of how well a company is utilizing its assets and the dollar per dollar rate that can turn assets into sales.

### **Working Capital Turnover**

*(Sales divided by Working Capital)*

This ratio measures the ability of the company to generate billed sales without tying up working capital. Working capital is calculated by subtracting Current liabilities from current assets.

### **Average Collection Period**

*(365 Days divided by Accounts Receivable Turns)*

Measures cash flow. High numbers indicate a negative impact on cash flow. Ratios exceeding 30 days should be of concern to the owner. Accounts Receivable Turns are calculated as Sales divided by Account Receivable balance.

### **Average Payables Days**

*(365 Days divided by Accounts Payable Turns)*

Measures cash flow. High numbers indicate a positive impact on cash flow. Ratios exceeding 30 days may be of concern to creditors. Accounts Payable turns are calculated as Direct Purchase Costs divided by Accounts Payable balance.

Ratio Name	Numerator	Denominator	Actual Ratio	Average D/B Contractor	High Profit D/B Contractor
Return On Assets	\$ 65,900	\$ 535,000	12.3%	14.2%	55.9%
Return On Equity	\$ 65,900	\$ 239,415	27.5%	32.0%	93.0%
Asset Turnover	\$ 1,500,000	\$ 535,000	2.8	8.4	9.2
Sales to Fixed Assets Working Capital Turnover	\$ 1,500,000	\$ 240,745	6.2	8.4	9.2
Average Collection Days	\$ 1,500,000	\$ 152,475	9.8	7.8	8.4
Average Payables Days	\$ 187,269	\$1,500,000 / 365	45.56	32.6	32.6
	\$ 40,370	\$471,000 / 365	32.28	20.7	15

### Interface Ratios

#### **Sales per FTE**

*(Sales divided by Full Time Staff Equivalents)*

This is a labor productivity ratio. It is best used as an internal year-to-year comparative staffing ratio, and secondarily as an external general industry comparative benchmark ratio.

It measures the sales dollars generated by a person in a year. The ratio uses annual sales in the numerator divided by the average fulltime equivalents (FTE's) employed during that year. An FTE is based on a range of 1600 - 2080 hours per year depending on market seasonality. Full year install markets should use 2080 hours (52 weeks times 40 hours per week). Short season markets should use 1600 hours (40 weeks times 40 hours per week). Total FTE's include all hourly people, office staff, sales staff, production / shop staff, and owner and management staff in the calculation of the total FTE's for the year.

In addition the calculation of the ratio must include an adjustment to the sales revenue dollar value. Subtract out materials and subcontractor revenues by applying an average markup and backing these dollar values out of the total sales revenue number.

#### **Sales per FTE Example Calculation**

Sales of \$1,500,000

Subtract Materials costs of \$223,200 + \$148,800 @ 50% average markup

Equals Adjusted sales of \$942,000

Subtract Subcontractor costs of \$93,000@20% average markup

Equals Adjusted sales of \$830,400

Production hours for crew paid during the year = 19,800

Production Season average (mid-length season) = 1800 hours per FTE

Other staffing – One owner, one FT sales/ designer, one FT production manager, one FT office administrator, one FT mechanic = 5.

Production FTE's are 24,000 hours divided by 1800 FT average to equal 11

Add to this number the other salaried FT staff to generate 16 FTE's

**Sales per FTE:** \$830,400 divided by 16 FTE's = \$51,900

**Realize rate (Sales per paid production hours)**

*(Sales divided by Full Time Staff Equivalents)*

This is a labor productivity and an estimating check ratio. It is best used as an internal year-to-year comparative earnings ratio, and secondarily as an external general industry comparative benchmark ratio. This ratio like the Sales per FTE ratio are GREATLY affected by local market conditions like competitor pricing policies, weather, customer perceived value of landscape, rental rates, vacancy rates, and labor rates.

It measures the sales dollars actually REALIZED and recovered per labor production hours paid. At a minimum, this dollar per hour rate had better exceed your imputed hourly labor bid rate (however you calculate your job estimates). Earning a realize below the standard hourly bid rate indicates swift profit erosion.

**Realize Rate Calculation**

Sales of \$1,500,000

Subtract Materials costs of \$223,200 + \$148,800 @ 50% average markup

Equals Adjusted sales of \$942,000

Subtract Subcontractor costs of \$93,000@20% average markup

Equals Adjusted sales of \$830,400

Production hours for crews paid during the year = 19,800

**Realize Rate:** \$830,400 divided by 19,800 = \$41.94 per hour

Ratios are both an internal management tool and an industry benchmarking tool to be used for budgeting and goal setting. Tracking of ratios over time and noting trends is most helpful in guiding effective management internal decision making and planning.