SCA Today

The Official Magazine of the Society of Commercial Arboriculture

Volume 23, No. 4

Managerial Accounting for Arborists

Part 5: Financing

By James Komen

This is the final article in a five-part series on Managerial Accounting. It relies upon terminology introduced in Part 1: Accounting Basics. It applies the concepts discussed in the other articles to the concept of financial leverage.

Financing

Many companies rely upon debt to finance their operations. Sometimes they simply don't have access to sufficient equity to make the investments to expand to meet market demand. Sometimes they may have access to the equity, but the cost of debt (interest paid) is less expensive than the cost of the additional equity (dividends paid). Either way, managing debt financing can become critical to many tree service companies.

There are different types of debt, depending on their intended use. Each one is associated with a different interest rate. What follows is a selection of the more common types:

- **Mortgage Loans:** Mortgage loans are secured by real estate. They typically have the lowest interest rates because the collateral is the least likely to lose its value. Loan amounts are typically 70%-75% of the cost of the real estate.
- **Fixed Asset Loans:** Fixed asset loans are secured by company equipment. Common fixed asset loans for tree service businesses are secured by vehicles and chippers. Loan amounts are typically 70%-100% of the cost of purchase.
- **Working Capital Loans:** Working capital loans are secured by the company's liquid assets. They are useful for helping businesses cover their prepaid expense asset accounts. They tend to have a higher interest rate because of the impermanence of the asset by which they are secured. Maximum loan amounts can be 10% of the annual revenue generated by the business.
- **Factoring:** Factoring loans are secured by the company's A/R. Sometimes customers take a long time to pay their obligations, resulting in a crippling reduction in the company's cash flow. With factoring, the lender pays the company a portion of the amount invoiced to the customer and then collects directly from the customer to repay the temporary loan. Loan amounts are typically 80%-90% of the invoiced amount.
- **Revolving Credit:** Credit cards and other revolving credit accounts are unsecured debt. They are intended for improving the liquidity of a company. When cash is temporarily unavailable and a purchase must be made, the transaction may be credited to that account. They tend to have the highest interest rate because they are only secured by the good faith of the business and its managers.

When a company is looking to expand or increase its cash reserves, managers may seek out loans secured by its various assets. There exists a different financing product available for nearly every different asset class, with an interest rate dependent upon the asset's behavior and the level of risk exposure to the lender. When the balance sheet clearly delineates between each of the asset classes, it is easier for managers to see potential sources of raising capital.

If the only asset tracked on the company's balance sheet is the cash in its bank account, then its financing options would be limited. If the company were to separate out each of its asset classes, it could present a better proposal to a lender for various types of collateral it could offer for financing.

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INDUSTRY CALENDAR

» Effective Report Writing: Guidance for Arborists
1/14/2019 Surrey, BC, Canada
» ISA Arborist Prep Course
1/14/2019 Oakland Park, FL
» Certified Arborist Preparatory Course
1/21/2019 Buffalo, NY
» Indiana Arborist Association Annual Conference
1/22/2019 Indianapolis, IN
» The Structure and Function of Trees
1/23/2019 Plant City, FL
» AMTOPP Annual Conference and Trade Show
1/27/2019 Fiarmont, MT
» Fruit Tree Pruning
2/4/2019 Seattle, WA
» Midwest Chapter-ISA Annual Conference and Trade Show
2/6/2019 St. Louis, MO
» Report Writing for Arborists
2/11/2019 Seattle, WA
» Tree Planting and Installation
2/20/2019 New Brunswick, NJ
» KAA 2019 Annual Conference
2/21/2019 Burlington, KY
» Tree Pruning
2/21/2019 New Brunswick, NJ
» Ohio Tree Care Conference
2/24/2019 Sandusky, OH
» ISA Arborist Prep Course
3/4/2019 Oakland Park, FL
» 2019 Mexican Tree Climbing Championship
3/7/2019 Oaxaca, Mexico
» Basic Tree Appraisal
3/7/2019 Seattle, WA
» Basics of Tree Biomechanics
3/25/2019 Bend, OR
» Tree School Basics - A 2-Day Short Course
3/28/2019 West Palm Beach, FL
» Preserving Veteran Trees
4/3/2019 Seattle, WA
» 2019 Asia Pacific Tree Climbing Championship
4/5/2019 Christchurch, New Zealand
» Basic Tree Identification
4/11/2019 Oregon City, OR
» Ohio Tree Climbing Championship
4/12/2019 Cincinnati, OH
» Trees and Construction
4/18/2019 Kelowna, BC, Canada
» 2019 International Tree Climbing Championship
8/9/2019 Knoxville, TN

Managerial Accounting

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When I started researching it, I was surprised how much capital was available to me as a small business owner. For a tree service company with annual revenues of $300K, I was maintaining equity of about $30K and no debt. With factoring, I have the option of borrowing 80% of my A/R, which could be $10K-$30K at any given time. With a working capital loan, I have the option of borrowing 10% of our annual revenues for a loan amount of up to $30K. With just these two loans, I could conceivably pull all of my equity out of the business for personal use and have the company be entirely debt-financed. Or I could re-invest that $40K into additional growth. $40K pulled out of my company could potentially be a down payment on a home purchase!

Larger companies with more assets would have even more options for obtaining financing for growth or paying back initial shareholder investments. With a balance sheet reflective of the company's true financial position, managers are able to clearly see the options available to them.

It is important to note that financing increases the ***leverage*** of a company. The company is able to do more with less capital. However, with increased leverage comes increased risk. A small unplanned downturn in business or economic conditions could have a much larger impact on the company's position. Therefore, managers have a heightened need for detailed accounting records so there are as few surprises as possible.

Conclusion

Making changes to accounting systems don't directly change the operations of a company. They simply re-allocate cost and value to paint a picture of the company's health. Ultimately, the reports generated by the company's accounting system have the potential to change management's perceptions of the company's financial well-being. How management perceives the company affects the decisions that are made and where the company is steered in the future.

This article series discussed accounting fundamentals and applied them to cost classification, depreciation, payroll allocation, and finance. When managers have a strong comprehension of these concepts and how they are applied to govern their company's ledger, they will be better able to direct their available resources to maximize the value of their companies.

James Komen is a consulting arborist in California specializing in risk assessment and tree appraisals. He employs principles of finance and accounting to help clients make informed management decisions for individual trees and for tree inventories. You can learn more about James from his website at www.jameskomen.com.