BUSINESS PRACTICES FOR SUSTAINABLE CONTRACTORS

Part Four—What are your financial statements telling you?

It can be tough for contractors to find the time to fully analyse their financial statements and understand the story they are telling them about the present condition of their business or future course. Besides the time involved, another major factor is many contractors do not have any training or experience in understanding financial statements.

One way to get the most from your financial data is to meet with your accountant on a regular basis and ensure you are asking the right questions, including what the key things are that they look for when analysing your statements.

Balance Sheet

Your balance sheet is a snapshot of your assets and liabilities at the end of each fiscal year. Despite being good to see where you land at the end of each year, the value of that snapshot diminishes as time passes. By the time you meet to go over it with your accountant, depending on the collection of your accounts receivable, asset purchases, taking on new debt and cash outlays it may be completely irrelevant and you would be better off looking at a copy from your internal accounting system.

Comparing your current assets to your current liabilities helps to measure your ability to pay off short-term obligations. The higher the number, the better your ability to cover short-term debts.

Another key ratio to look at is your total liabilities over your total assets. This tells you how many of the company's assets are financed with debt versus self financed. The lower the number the less reliant your company is on third-party debt.

Lenders review both ratios when making a decision to lend to your business.

Income Statement

Your income statement is a report of how your business did during the year. Its relevance does not diminish over time like the balance sheet. If a contractor is going to look at one statement in detail it should be the income statement.

Presenting a contractor's income statement in different ways can create some insightful analysis. Ideally a contractor's income statement should be broken out into the direct costs of production and administration costs. Dividing the income statement components by production volume shows your financial performance on a cubic metre basis.

This helps to determine your overall profitability as well as profitability by phase. It allows a contractor to focus on areas where they may be able to make more money by focusing on being more efficient. It also allows a contractor to compare their logging rate to their costs. Shortfalls in any of these areas require immediate attention.

Key ratios to do with your income statement that lenders and owners should focus on is the company's operating income over interest expense and operating income over interest and principal portions of debt. Both are measures of the company's ability to make its debt payments and stay current with their lenders.

Profitability

The other area a contractor should be focusing on is the profitability of their business. This isn't just the bottom line on the financial statements but how it relates to the revenue, costs, invested equity and assets of the business.

Earnings Before Interest, Tax, Depreciation and Amortization (EBITDA)

EBITDA measures profitability without the effects of financing or capital assets against the prior year or industry benchmarks, as it focuses on operating profits. For example, when a company obtains financing to purchase new equipment it incurs higher interest and amortization costs and a lower net income than a company which runs older assets, even though these new assets might have higher efficiency and capacity. Comparing EBITDA will allow companies to focus on the operating profitability that management was able to generate on sales regardless of financing.

Return on Assets (ROA)

Return on assets is calculated as net operating income divided by total assets. A higher percentage is more desirable.

ROA measures how profitable your assets are. This is valuable when comparing ROA between different projects or investments that your company is involved in or against an industry benchmark, as it identifies which assets are generating the most income. An example of the usefulness of this measure is to compare the ROA realized by operations versus other investments. Realizing a low or declining ROA, would indicate to management that it should assess whether the assets may be put to better use elsewhere, such as into new assets or operation to facilitate growth of the business, or into higher-yield investments.

Conclusion

These examples are just a fraction of what your financials can tell you. Every contractor will have a different area they are interested in. It is good to ask others in the industry what they focus on. By spending some time with your numbers you can increase your profits.

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