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All Is Not Paradise in Eden's Garden: Part 1

Joe and Kaitlin Eden, co-owners of Eden's Garden, a small nursery, lawn, and garden supply business, have just received their year-end financial statements from their accountant. At their last meeting with their accountant, Shelley Edison, three months ago, the Edens had mentioned that they seemed to be having trouble paying their bills on time. "Some of our suppliers have threatened to put us on 'credit hold,'" said Joe.

Balance Sheet, Eden's Garden

Assets		
Current Assets		
Cash		$6,457
Accounts Receivable	$29,152	
Less Allowance for Doubtful Accounts	$3,200	$25,952
Inventory		$88,157
Supplies		$7,514
Prepaid Expenses		$1,856
Total Current Assets		$129,936
Fixed Assets		
Land		$59,150
Buildings	$51,027	
Less Accumulated Depreciation	$2,061	$48,966
Autos	$24,671	
Less Accumulated Depreciation	$12,300	$12,371
Equipment	$22,375	
Less Accumulated Depreciation	$1,250	$21,125
Furniture and Fixtures	$10,295	
Less Accumulated Depreciation	$1,000	$9,295
Total Fixed Assets		$150,907
Intangibles (Goodwill)		$0
Total Assets		$280,843
Liabilities		
Current Liabilities		
Accounts Payable		$54,258
Notes Payable		$20,150
Credit Line Payable		$8,118
Accrued Wages/Salaries Payable		$1,344
Accrued Interest Payable		$1,785
Accrued Taxes Payable		$1,967
Total Current Liabilities		$87,622
Long-Term Liabilities		
Mortgage		$72,846
Note Payable		$47,000
Total Long-Term Liabilities		$119,846
Owner's Equity		
Sam Lloyd, Capital		$73,375
Total Liabilities and Owner's Equity		$280,843

Income Statement, Eden's Garden

Net Sales Revenue*		**$689,247**
Cost of Goods Sold		
Beginning Inventory, 1/1/xx	$78,271	
+ Purchases	$403,569	
Goods available for Sale	$481,840	
− Ending Inventory, 12,31/xx	$86,157	
Cost of Goods Sold		$395,683
Gross Profit		$293,564
Operating Expenses		
Advertising	$22,150	
Insurance	$9,187	
Depreciation		
Building	$26,705	
Autos	$7,895	
Equipment	$11,200	
Salaries	$116,541	
Uniforms	$4,018	
Repairs and Maintenance	$9,097	
Travel	$2,658	
Entertainment	$2,798	
Total Operating Expenses		$212,249
General Expenses		
Utilities	$7,987	
Telephone	$2,753	
Professional Fees	$3,000	
Postage	$1,892	
Payroll Taxes	$11,589	
Total General Expenses		$27,221
Other Expenses		
Interest Expense	$21,978	
Bad check Expense	$679	
Miscellaneous expense	$1,248	
Total Other Expenses		$23,905
Total Expenses		$263,375
Net Income		$30,189

*Credit sales represented $289,484 of this total.

(continued)

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"I think you need to sit down with me very soon and let me show you how to analyze your financial statements so you can see what's happening in your business," Edison told them at that meeting. Unfortunately, that was the beginning of Eden's Garden's busy season, and the Edens were so busy running the company that they never got around to setting a time to meet with Shelley.

"Now that business has slowed down a little, perhaps we should call Shelley and see what she can do to help us understand what our financial statements are trying to tell us," said Kaitlin.

"Right. Before it's too late to do anything about it," said Joe, pulling out the following financial statements.

1. Assume the role of Shelley Edison. Using the financial statements for Eden's Garden, calculate the 12 ratios covered in this chapter.
2. Do you see any ratios that, on the surface, look suspicious? Explain.

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entrepreneurs must understand how to interpret them and apply them to managing their businesses more effectively and efficiently.

ENTREPRENEURIAL PROFILE: Linda Nespole: Hi-Shear Technology With the help of financial ratios, Linda Nespole, a top manager at Hi-Shear Technology, an aerospace subcontracting company in Torrance, California, noticed the company's performance beginning to slip. Given the signals her analysis revealed, she immediately devised a strategy to restore Hi-Shear's financial position, focusing first on cost-cutting measures. Simply charting the company's major costs led Nespole to discover leaking water pipes and inefficient lighting that were driving up costs unnecessarily. Some basic repairs lowered utility costs significantly, and a new, more efficient lighting system paid for itself in just six months. Nespole's cost-saving attitude took hold throughout the entire company, and soon all 125 employees were finding ways to keep costs down—from switching long-distance carriers to cutting the cost of its 401(k) retirement plan by 30 percent.[29] ■

Not every business measures its success with the same ratios. In fact, key performance ratios vary dramatically across industries and even within different segments of the same industry. Entrepreneurs must know and understand which ratios are most crucial to their companies' success and focus on monitoring and controlling those. Sometimes business owners develop ratios and measures that are unique to their own operations to help them achieve success. Known as **critical numbers (or key performance indicators [KPIs])**, these indicators measure key financial and operational aspects of a company's performance. When these critical numbers are headed in the right direction, a business is on track to achieve its objectives. Norm Brodsky, owner of a successful document storage and delivery business in New York City, breaks his business into four categories and tracks critical numbers for each one. Every Monday morning, he receives a report comparing the previous week's critical numbers to those of the previous 28 weeks and the same week for the previous three years. "In 30 seconds, I can see what's going on in every part of my delivery business," he says. "I get another sheet for my storage business because I need to track a different set of numbers there, but the idea is the same."[30] Examples of critical numbers at other companies include the following:

critical numbers (key performance indicators [KPIs]) indicators that measure key financial and operational aspects of a company's performance; when these numbers are moving in the right direction, a business is on track to reach its objectives.

- A bank's "happy-to-grumpy" ratio, which measures the level of satisfaction of its employees. Studies show that employees at the bank who score high on this index are more productive and receive higher customer satisfaction ratings.[31]
- Sales per labor hour at a supermarket.
- The number of new boxes put into storage each week in a records storage business. "Tell me how many new boxes came in during [a particular week]," says Norm Brodsky, owner of CitiStorage, the successful records storage company, "and I can tell you our overall sales figure for [that week] within one or two percent of the actual figure."[32]
- Food costs as a percentage of sales for a restaurant. When rapidly rising flour and cheese prices pushed food costs as a percentage of sales from the normal 34 percent to 40 percent

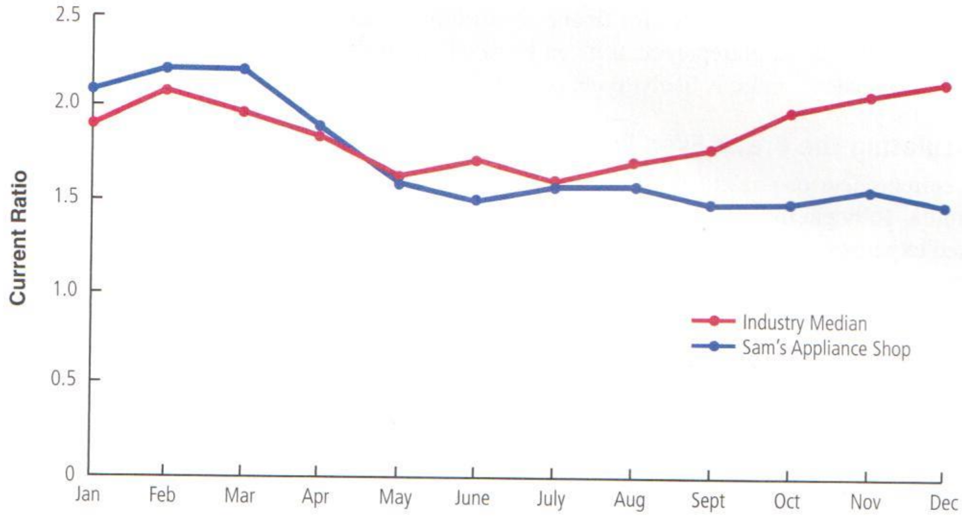

FIGURE 11.5
Trend Analysis of Ratios

this level of activity, sales revenue equals expenses—that is, the firm "breaks even." A business that generates sales that are greater than its break-even point will produce a profit, but one that operates below its break-even point will incur a net loss. By analyzing costs and expenses, an entrepreneur can calculate the minimum level of activity required to keep a company in operation. These techniques can then be refined to project the sales needed to generate the desired profit. Most potential lenders and investors expect entrepreneurs to prepare a break-even analysis to assist them in evaluating the earning potential of the new business. In addition to its being a

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All Is Not Paradise in Eden's Garden: Part 2

Remember Joe and Kaitlin Eden, co-owners of Eden's Garden? Assume the role of Shelley Edison, their accountant. Tomorrow, you have scheduled a meeting with them to review their company's financial statements and to make recommendations about how they can improve their company's financial position. Use the following worksheet to summarize the ratios you calculated earlier in this chapter. Then compare them against the industry averages from the RMA's *Annual Statement Studies*.

Ratio Comparison

Ratio	Eden's Garden	Garden Supply Industry Median*
Liquidity Ratios		
Current ratio		1.4
Quick ratio		0.5
Leverage Ratios		
Debt ratio		0.6
Debt to net worth ratio		1.8
Times interest earned ratio		2.6
Operating Ratios		
Average inventory turnover ratio		5.6
Average collection period ratio		9 days
Average payable period ratio		17 days
Net sales to total assets ratio		3.0
Profitability Ratios		
Net profit on sales ratio		7.5%
Net profit to assets ratio		9.1%
Net profit to equity ratio		15.0%

*Risk Management Association's *Annual Statement Studies*.

1. Analyze the comparisons you have made of Eden's Garden's ratios with those from RMA. What red flags do you see?
2. What might be causing the deviations you have observed?
3. What recommendations can you make to the Edens to improve their company's financial performance in the future?