

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1997

Commission file number: 0-11917

THE DAVEY TREE EXPERT COMPANY  
(Exact name of Registrant as specified in its charter)

Ohio  
(State of Incorporation)

34-0176110  
(IRS Employer Identification No.)

1500 North Mantua Street  
P. O. Box 5193  
Kent, Ohio  
(Address of principal executive offices)

44240-5193  
(Zip Code)

Registrant's telephone number, including area code: (330) 673-9511

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Shares, \$1 par value

The Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirement for the past 90 days.

Yes  No

The disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

The aggregate "market value" (See Item 5 hereof) of voting stock held by non-affiliates of the Registrant at March 23, 1998 (excluding the total number of Common Shares reported in Item 12 hereof), was \$111,765,962.

Common Shares outstanding at March 23, 1998: 4,290,440.

Documents incorporated by reference: Portions of the Registrant's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders (Part III).

Index to Exhibits is located on sequential page 14.

## PART I

### **ITEM 1. BUSINESS.**

**GENERAL.** The Davey Tree Expert Company, which was incorporated in 1909, and its subsidiaries (the "Registrant") are in the business of providing horticultural services to a variety of residential, commercial, corporate, institutional and governmental customers. Horticultural services include the treatment, preservation, maintenance, cultivation, planting and removal of trees, shrubs and other plant life and also include the practices of landscaping, tree surgery, tree feeding, tree spraying, and line clearing for public utilities. Horticultural services also involve the application of scientifically formulated fertilizers, herbicides and insecticides with hydraulic spray equipment on residential and commercial lawns. The Registrant also provides a full range of natural resource management solutions, including urban and utility forestry research and development, natural resources consulting, and environmental planning.

**COMPETITION AND CUSTOMERS.** The Registrant is one of the largest national organizations in the horticultural services industry. The Registrant competes with other national and local firms with respect to its services, although the Registrant believes that no other firm, whether national or local, offers the range of services that it offers.

Competition in private horticultural services is generally localized but very active and widespread. The principal methods of competition are advertising, customer service, image, performance and reputation. The Registrant's program to meet its competition stresses the necessity for its employees to have and project to the customers a thorough knowledge of horticulture and utilization of modern, well-maintained equipment. Pricing is not always a critical factor in a customer's decision. Pricing is, however, the principal method of competition in providing horticultural services to utility customers, although in most instances consideration is given to reputation and past production performance.

The Registrant provides a wide range of horticultural services to private companies, public utilities, local, state and federal agencies, and a variety of industrial, commercial and residential customers. During 1997, the Registrant had sales of approximately \$67,000,000 (23% of total sales) to Pacific Gas & Electric Company.

**REGULATION AND ENVIRONMENT.** The Registrant's facilities and operations, in common with those of the industry generally, are subject to governmental regulations designed to protect the environment. This is particularly important with respect to the Registrant's services regarding insect and disease control, because these services involve to a considerable degree the blending and application of spray materials, which require formal licensing in most areas. The constant changes in environmental conditions, environmental awareness, technology and social attitudes make it necessary for the Registrant to maintain a high degree of awareness of the impact such changes have on the market for its services. The Registrant believes that it is in substantial compliance with existing federal, state and local laws regulating the use of materials in its spraying operations as well as the other aspects of its business that are subject to any such regulation.

**MARKETING.** The Registrant solicits business from residential and commercial customers principally through direct mail programs and to a lesser extent through the placement of advertisements in national magazines and trade journals and in local newspapers and "yellow pages" telephone directories. Business from utility customers is obtained principally through negotiated contracts and competitive bidding. All sales and services are carried out through personnel who are direct employees. The Registrant does not generally use agents and does not franchise its name or business.

**SEASONALITY.** The Registrant's business is seasonal, primarily due to fluctuations in horticultural services provided to residential and commercial customers and to a lesser extent by budget constraints imposed on its utility customers. Because of this seasonality, the Registrant has historically incurred losses in the first quarter, while sales and earnings are generally highest in the second and third quarters of the calendar year. Consequently, this has created heavy demands for additional working capital at various times throughout the year. The Registrant borrows primarily against bank commitments in the form of a revolving credit agreement with two banks to provide the necessary funds.

**OTHER FACTORS.** Rapid changes in equipment technology require a constant updating of equipment and processes to ensure competitive services to the Registrant's clients. Also, the Registrant must continue to assure its compliance with the Occupational Safety and Health Act. In keeping with these requirements, and to equip the Registrant for continued growth, capital expenditures in 1997 and 1996 were approximately \$27,003,000 and \$18,121,000, respectively.

The Registrant owns several trademarks including "Davey", "Davey and design", "Arbor Green", "Davey Tree and design", "Davey Expert Co. and design" and "Davey and design (Canada)". Through substantial advertising and use, the Registrant is of the opinion that these trademarks have become of value in the identification and acceptance of its products and services.

**EMPLOYEES.** The Registrant employs between 5,000 and 5,900, depending upon the season, and considers its employee relations to be good.

**FOREIGN AND DOMESTIC OPERATIONS.** The Registrant sells its services to customers in the United States and Canada.

The Registrant does not consider its foreign operations to be material and considers the risks attendant to its business with foreign customers, other than currency exchange risks, to be not materially different from those attendant to business with its domestic customers.

## ITEM 2. PROPERTIES.

The following table lists certain information with respect to major properties owned by the Registrant and used in connection with its operations.

<u>LOCATION</u>	<u>ACREAGE</u>	<u>BUILDING SQ. FT.</u>
Cincinnati, Ohio	2.5	8,800
Livermore, California	12.0	29,737
Winter Park, Florida	1.0	5,850
Chamblee, Georgia	1.9	6,200
East Dundee, Illinois	4.0	7,500
Indianapolis, Indiana	1.5	5,000
Troy, Michigan	2.0	7,200
Cheektowaga, New York	6.9	2,800
Bayport, New York	2.0	7,000
Charlotte, North Carolina	3.1	4,900
Kent, Ohio (multiple parcels) - Corporate Headquarters	105.0	111,608
Toledo, Ohio	.5	4,300
Wooster, Ohio - Nursery	322.8	13,194
Columbus, Ohio	8.0	15,925
West Babylon, New York	.9	14,100
Chantilly, Virginia	4.0	5,700
Downsview, Ontario, Canada	.5	3,675
Baltimore, Maryland	3.4	22,500
Lancaster, New York	3.0	6,624
Bettendorf, Iowa	.5	478
Richmond, Virginia	.7	2,586
Mecklenburg County, North Carolina	15.6	-0-
Stow, Ohio	7.4	14,100
West Carlton Twp., Ontario, Canada	3.1	4,000
Nanaimo, British Columbia, Canada	1.0	4,742
Edmonton, Alberta, Canada	.7	2,900
Houston, Texas	1.5	7,000
Plymouth, Minnesota	2.7	11,750
Gaithersburg, Maryland	2.1	7,200
Lachine, Quebec, Canada	.5	2,300
Gibsonia, Pennsylvania	5.9	7,100
Lawrence, Pennsylvania	3.5	7,200
Jacksonville, Florida - Nursery	279.0	5,300

The Registrant also rents approximately 70 other premises for office and warehouse use. The Registrant believes that all of these properties have been adequately maintained and are suitable and adequate for its business as presently conducted.

**ITEM 3. LEGAL PROCEEDINGS.**

There are no legal proceedings, other than ordinary routine litigation incidental to the business, to which the Registrant or any of its subsidiaries is a party or of which any of their property is the subject. This routine litigation is not material to the Registrant.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

No matter was submitted during the fourth quarter of 1997 to a vote of security holders, through the solicitation of proxies or otherwise.

Executive Officers of the Registrant (included pursuant to Instruction 3 to paragraph (b) of Item 401 of Regulation S-K). The executive officers of the Registrant and their present positions and ages are as follows:

<u>NAME</u>	<u>POSITION</u>	<u>AGE</u>
R. Douglas Cowan	Chairman, President and Chief Executive Officer	57
David E. Adante	Executive Vice President, Chief Financial Officer and Secretary-Treasurer	46
Karl J. Warnke	Executive Vice President and General Manager, Utility Services	46
Howard D. Bowles	Vice President and General Manager, Davey Tree Surgery Company	54
C. Kenneth Celmer	Vice President and General Manager, Residential Services	51
Bradley L. Comport, CPA	Corporate Controller	46
Dr. Roger C. Funk	Vice President and General Manager, The Davey Institute	53
Rosemary T. Nicholas	Assistant Secretary	54
Gordon L. Ober	Vice President - New Ventures	48
Richard A. Ramsey	Vice President and General Manager, Commercial Services	48
Wayne M. Parker	Vice President - Northern Operations, Utility Services	42

Mr. Cowan was elected Chairman, President and Chief Executive Officer in May 1997. Prior to that time, he served as President and Chief Executive Officer since before 1993.

Mr. Adante was elected Executive Vice President, Chief Financial Officer and Secretary - Treasurer in May 1993. Prior to that time, he served as Vice President, Chief Financial Officer and Secretary - Treasurer since before 1993.

Mr. Warnke was elected Executive Vice President and General Manager - Utility Services in May 1993. Prior to that time, he served as Vice President and General Manager - Utility Services since before 1993.

Mr. Bowles was elected Vice President and General Manager of Davey Tree Surgery Company in January 1992.

Mr. Celmer was elected Vice President and General Manager - Residential Services in January 1995. Prior to that time, he served as Vice President - Eastern Operations, Residential and Commercial Services since before 1993.

Mr. Comport was elected Corporate Controller in May 1990.

Dr. Funk was elected Vice President and General Manager - The Davey Institute in May 1996. Prior to that time he served as Vice President - Human and Technical Resources since before 1993.

Ms. Nicholas was elected Assistant Secretary in May 1982.

Mr. Ober was elected Vice President - New Ventures in March 1986.

Mr. Ramsey was elected Vice President and General Manager - Commercial Services in January 1995. Prior to that time, he served as Vice President - Western Operations, Residential and Commercial Services since before 1993.

Mr. Parker was elected Vice President - Northern Operations, Utility Services in May 1994. Prior to that time and since before 1993, he served in several positions in utility operations.

Officers of the Registrant serve for a term of office from the date of their election to the next organizational meeting of the Board of Directors and until their respective successors are elected.

## PART II

### **ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.**

At December 31, 1997, 1996, and 1995 the number of Common Shares issued were 8,728,440 for each date. At those respective dates, the number of shares in the treasury were 4,429,205, 4,209,623 and 4,104,976.

The Registrant's Common Shares are not listed or traded on an established public trading market and market prices are, therefore, not available. Semi-annually, for purposes of the Registrant's 401KSOP and ESOP, the fair market value of the Registrant's Common Shares, based upon the Registrant's performance and financial condition, is determined by an independent stock valuation firm.

The Registrants' board of directors declared a 2 for 1 stock split in the form of a stock dividend on September 27, 1996. (See Note 1 to the Financial Statements on page F-9 of this Annual Report on Form 10-K.)

As of March 23, 1998, there were 1,757 recorded holders of the Registrant's Common Shares. During the years ended December 31, 1997, December 31, 1996 and December 31, 1995, the Registrant paid dividends of \$.34, \$.295, and \$.275, respectively, per share. Approximately one quarter of the total dividend paid is paid in each of the four quarters. The Registrant's agreements with its lenders allow for the payment of cash dividends provided that the terms and conditions of the agreements, particularly those dealing with its shareholders' equity, fixed charge coverage ratio and maximum consolidated funded debt to consolidated funded debt plus consolidated net worth ratio, are maintained. (See Note 5 to the Financial Statements on page F-14 of this Annual Report on Form 10-K.)

**ITEM 6. SELECTED FINANCIAL DATA.**

	<u>Years Ended December 31</u>				
	<u>1997</u>	<u>1996</u>	<u>1995</u>	<u>1994</u>	<u>1993</u>
	<i>(Dollars in Thousands, except per share data)</i>				
<b>Operating Results:</b>					
Revenues	\$ 295,079	\$ 266,934	\$ 229,682	\$ 209,683	\$ 218,521
Earnings from Continuing Operations	\$ 11,279	\$ 8,759	\$ 6,137	\$ 4,189	\$ 6,107
Earnings from Continuing Operations Per Common Share	\$ 2.57	\$ 1.92	\$ 1.29	\$ .85	\$ 1.22
Earnings from Continuing Operations Per Common Share - Assuming Dilution	\$ 2.39	\$ 1.86	\$ 1.27	\$ .84	\$ 1.17
<b>At Year End:</b>					
Total Assets	\$ 127,825	\$ 111,386	\$ 104,161	\$ 98,486	\$ 99,780
Total Long-Term Debt	\$ 24,104	\$ 19,640	\$ 17,049	\$ 21,124	\$ 26,778
Cash Dividends Per Common Share	\$ .34	\$ .295	\$ .275	\$ .26	\$ .24

In 1995 the Registrant sold its interior plant care business. Operating results for all years presented have accordingly been restated for this discontinued operation. (See Note 13 to the Financial Statements on page F-21 of this Annual Report on Form 10-K.)

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.****LIQUIDITY AND CAPITAL RESOURCES**

Operating activities provided \$26,934,000 in cash, an increase of \$9,830,000 when compared to the \$17,104,000 provided in 1996. The increase was primarily attributable to higher net earnings and depreciation. The increase was also due to a lower increase in accounts receivable, as well as in accounts payable and accrued liabilities, insurance liabilities, and other liabilities. These increases were partially offset by an increase in other assets.

Record net earnings of \$11,279,000 increased \$2,520,000 or 28.8% when compared to the \$8,759,000 earned in 1996. All of the Registrant's services contributed to the increase through higher operating earnings, particularly utility and commercial services. Utility services continued to be positively influenced by additional work performed by the Registrant's western utility operations. To a large extent this additional work has resulted from more stringent utility line clearance standards promulgated by the state of California. Given the continuance of these standards, the Registrant expects that, while the rate of increase in utility revenues and operating earnings will not be as pronounced as in 1997, their levels will be maintained generally, subject to contract renewals and new contracts obtained in the ordinary course of business. Commercial services increased their revenues and operating earnings significantly when compared to 1996, its inaugural year of operation; its earnings as well as most of the Registrant's other services also benefited from additional work obtained as a result of damage caused by a July storm in southeast Michigan.

Accounts receivable increased by \$4,091,000 in 1997. Nevertheless, this represents an improvement of \$1,092,000 from the increase experienced in 1996 and a corresponding improvement to the increase in net cash provided by operating activities. Despite this lower increase in accounts receivable, the Registrant's days outstanding have increased 2.8 days to 62.5 days in the aggregate. Even though an improvement of about 2.4 days was realized throughout most of the Registrant's U.S. operations, it was more than offset by a deterioration of days outstanding in the Registrant's western U.S. operations, more specifically with its major U.S. customer. The days outstanding with respect to this customer have fluctuated during the course of 1997. While the Registrant is not concerned as to the collectibility of this account or the overall collectibility of accounts, it considers the current level of accounts receivable and days outstanding as clearly unacceptable, and will continue its work to reduce both. The Registrant also performs ongoing credit evaluations of its customers' financial condition for collection purposes, and when determined necessary, it provides an allowance for doubtful accounts.

Accounts payable and accrued liabilities provided \$2,606,000 in cash, \$1,283,000 more than in 1996. The net increase was principally a function of higher accruals associated with the Registrant's increased levels of revenue and profitability.

Insurance liabilities increased \$2,539,000, which was only \$598,000 higher than that experienced in 1996. The increase is primarily due to accruals associated with the addition of the Registrant's auto and general liability exposures to its self-insured program in late 1996. The Registrant continues to benefit from generally favorable claims experience in its casualty liability exposures, and from a further stabilization in the level of estimated ultimate costs resulting from a relatively mature self-insurance program, particularly with respect to workers compensation. The most significant estimates made by the Registrant that affect the amounts reported in the financial statements and accompanying notes are those relating to its insurance liabilities. (See Note 2 on page F-11 of this Annual Report on Form 10-K).

Other liabilities provided \$1,245,000 in cash, an increase of \$4,113,000 when compared to the \$2,868,000 used during 1996. This increase resulted primarily from an acceleration of estimated income tax payments in the prior year.

Other assets used \$2,876,000 in cash, an increase of \$1,910,000 when compared to the \$966,000 used in 1996. The current year increase resulted primarily from an escrow deposit on real property which will be used as a branch office facility. The transaction to acquire the property will be completed in 1998.

Investing activities used \$26,314,000 in 1997, an increase of \$9,051,000 when compared to the \$17,263,000 used in 1996. The increase was attributable to higher capital expenditures necessitated by the growth in all services, particularly the Registrant's western utility operations. The Registrant believes its capital expenditures and 1998 capital budget of approximately \$26,000,000 are consistent with its plan to expand services, maintain equipment on existing operations, and implement its new enterprise wide information system, discussed in more detail under "Results of Operations."

Financing activities used \$525,000 in 1997, \$159,000 less than that used in 1996, and \$8,676,000 less than in 1995. In 1995, the Registrant significantly reduced its capital expenditures and net of borrowings repaid \$5,138,000 in long-term debt. In 1997 and 1996 the Registrant increased its level of capital expenditures which were partially funded by net borrowings of \$4,978,000 and \$2,444,000 respectively. In 1997 and 1995 the Registrant repurchased \$5,918,000 and \$4,853,000 of its common shares, respectively, compared with only \$3,045,000 in 1996. The increase in 1997 was mainly due to shares redeemed from a trust that had been established by a former employee's family, while the higher 1995 level resulted from a significant repurchase of shares held by a former vice president. In the current year, a relatively higher level of treasury share sales partially offset the increase in share repurchases.



At December 31, 1997, the Registrant's principal source of liquidity consisted of \$722,000 in cash and cash equivalents; short-term lines of credit and amounts available to be borrowed from banks via notes payable totaling \$4,562,000, of which \$860,000 had been used at the end of the year; and a revolving credit agreement in the amount of \$35,000,000, of which \$20,800,000 had been drawn and \$6,955,000 was considered drawn to cover outstanding standby letters of credit; and an available \$5,000,000 temporary line of credit. Including the outstanding balance on the term note agreement of \$4,800,000, the Registrant's credit facilities now total \$49,000,000. The Registrant believes its available credit will exceed credit requirements, and that its liquidity is adequate.

## LIQUIDITY MEASUREMENTS

Management uses these measurements to gauge the Registrant's ability to meet current working capital requirements and the extent by which capital expenditures are funded by internally generated "cash flow".

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Working Capital	\$ 19,194	\$ 19,283	\$ 12,493
Current Ratio	1.6:1	1.7:1	1.4:1
Cash Flow from Net Earnings, Depreciation & Amortization	\$ 28,654	\$ 23,449	\$ 19,574
Capital Expenditures	\$ 27,003	\$ 18,121	\$ 13,297
Cash Flow to Capital Expenditures Ratio	1.1:1	1.3:1	1.5:1
Cash Flow as % of Revenues	9.7%	8.8%	8.5%

## LEVERAGE MEASUREMENTS

These ratios measure the extent to which the Registrant has been financed by debt, or, put another way, the proportion of the total assets employed in the business that have been provided by creditors as compared to shareholders. Debt is defined as total liabilities.

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Equity to Debt Ratio	.83:1	.89:1	.81:1
Debt as % of Assets	54.7%	52.9%	55.3%
Equity as % of Assets	45.3%	47.1%	44.7%

At the end of 1997, these measurements reflect a greater degree of leverage when compared with 1996 due primarily to the additional borrowings incurred to fund the significantly higher level of capital expenditures.

## COMMON SHARE MEASUREMENTS

These measurements assist shareholders in assessing the Registrant's earnings performance, dividend payout and equity position as related to their shareholdings.

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Net earnings per share – assuming dilution	\$ 2.39	\$ 1.86	\$ 1.32
Dividends per Share	\$ .34	\$ .295	\$ .275
Book Value per Share	\$ 13.46	\$ 11.61	\$ 10.07
Market Valuation per Share	\$ 26.05	\$ 18.20	\$ 13.56

Net earnings per share – assuming dilution includes the dilutive effects of employee and director stock options in each of the years presented. Dividends were again increased in 1997. In 1997, they were increased by a total of \$.045 per share, or 15.3% over 1996, compared to an increase in 1996 of \$.02 per share or 7.3% over 1995. It is the Registrant's objective to provide a fair return on investment to its shareholders through improved dividends as long as the Registrant can financially justify this policy. The fact that dividends have increased each year since 1979 reflects that objective.

## ASSET UTILIZATION MEASUREMENTS

Management uses these measurements to evaluate its efficiency in employing assets to generate revenues and returns.

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Average Assets Employed (in 000's)	\$ 119,606	\$ 107,774	\$ 101,324
Asset Turnover (Revenues to Average Assets)	2.5	2.5	2.3
Return on Average Assets	9.4%	8.1%	6.2%

## RESULTS OF OPERATIONS

Revenues of \$295,079,000 for the year increased \$28,145,000 or 10.5% when compared to the \$266,934,000 generated in 1996. This compares with increases of 16.2% and 9.5% in 1996 and 1995, respectively. The current year improvement was primarily due to increased revenues realized by the Registrant's Utility and Consulting services in its western operations, as well as higher Residential and Commercial service revenues. Residential and Commercial services continue to be favorably influenced by generally good economic conditions and heightened sales efforts. The increase in Western Utility and Consulting revenues resulted from the additional work obtained with several western utility customers and the Registrant's major U.S. customer. The 1997 revenues of \$67,000,000 earned by the Registrant with this customer represent a significant concentration (See Note 10 to the Financial Statements on page F-20 of this Annual Report on Form 10-K). The Registrant anticipates that 1998 revenues will approximate those earned in 1997.

Operating costs of \$197,726,000 increased \$14,299,000 over 1996 but as a percentage of revenues they declined 1.7% to 67.0%. The percentage improvement was generally the result of a higher level of revenues across all services, but was more specifically influenced by the lower operating costs associated with higher Residential, Commercial and Consulting service revenues. These services, when compared to other services, positively influence operating costs in that they are generally higher priced services with inherently higher gross margins and attendant lower operating costs. In particular, Consulting services are far less capital intensive and any increase in these revenues relative to the Registrant's other services have benefited its cost structure. As previously discussed, the Registrant anticipates that 1998 revenues will approximate those earned in 1997. It also expects a reduction in Consulting service revenues, primarily due to the substantial completion of a major contract during the third quarter of 1997. For these reasons, the Registrant believes that as a percentage of revenues operating costs in 1998 will approximate, or slightly exceed, 1997 levels.

Selling costs for 1997 increased \$4,257,000 to \$37,832,000 when compared to the \$33,575,000 experienced last year, and as a percentage of revenues they increased .2% to 12.8%. The dollar and percentage increases are primarily the result of higher commissions and branch office expenses associated with higher Residential and Commercial service revenues, as well as increased travel and other sales costs related to the Registrant's Consulting services.

General and administrative expense of \$20,297,000 was \$2,081,000 higher than in 1996, and as a percentage of revenues these costs increased .1% to 6.9%. Ordinarily, these expenses should decline as a percentage of revenues as revenues increase; however, in the current year the Registrant has incurred expenditures to complete the development of its information technology plan for the purpose of replacing its existing legacy systems with a new enterprise wide information system. Of primary importance and in accord with the information technology plan, the new system will significantly enhance the Registrant's processes and its ability to support future growth. Equally important, the software vendor has represented that this new system is year 2000 compliant. Even so, the Registrant recognizes that it must also assess the year 2000 readiness of external entities with which it interfaces. In January, 1998, the Registrant acquired and commenced implementation of this new information system. The Registrant estimates that implementation will be completed over an eighteen month period. The Registrant projects its ultimate cost, including third party consulting fees, hardware, and other costs to be approximately \$8,500,000; however, the Registrant believes a significant portion will be capitalizable. The Registrant anticipates that general and administrative expense, as a percentage of revenues, will be higher than existing levels over the term of this system implementation. This is anticipated because certain costs such as data conversion, training, and business process reengineering must be expensed as incurred. The Registrant does however believe that, over the long term, these costs will decline by virtue of having acquired and implemented this system.

Depreciation and amortization of \$17,375,000 increased \$2,685,000 or .4% as a percentage of revenues. The dollar and percentage increases are the result of relatively higher capital expenditures, in the last two years particularly, for equipment to support Utility, Residential and Commercial services. In 1998, the Registrant anticipates that depreciation expense will approximate \$17,500,000.

Interest Expense of \$2,703,000 was \$246,000 higher than last year, but as a percentage of revenues, it remained constant at .9%. The dollar increase was mainly due to higher overall debt levels in 1997.

As a result of the above factors, earnings before income taxes increased \$4,410,000 to \$19,251,000 or 6.5% as a percentage of revenues. The tax provisions for 1997, 1996 and 1995 resulted in effective tax rates of 41.4%, 41.0% and 39.3%, respectively. (See Note 9 of the Financial Statements on page F-19 on this annual report on Form 10-K).

The Registrant's net earnings of \$11,279,000 increased \$2,520,000 or 28.8% compared to 1996 and as a percentage of revenues they improved .5% to 3.8%.

**ITEM 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.**

The independent auditors' report, the audited consolidated financial statements, and the notes to the audited consolidated financial statements required by this Item 8 appear on pages F-1 through F-21 of this Annual Report on Form 10-K.

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.**

Not Applicable

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.**

Reference is made to Part I of this Report for information as to executive officers of the Registrant.

The information regarding directors of the Registrant appearing under the heading "Election of Directors" in the Registrant's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders is hereby incorporated by reference.

**ITEM 11. EXECUTIVE COMPENSATION.**

The information regarding compensation of the Registrant's executive officers appearing under the heading "Remuneration of Executive Officers" in the Registrant's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders is hereby incorporated by reference.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.**

The information regarding the security ownership of certain beneficial owners and management appearing under the heading "Ownership of Common Shares" in the Registrant's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders is hereby incorporated by reference.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.**

The information regarding certain relationships and related transactions appearing under the headings "Election of Directors" and "Indebtedness of Management" in the Registrant's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders is hereby incorporated by reference.

**PART IV**

**ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K.**

(a) (1) and (a) (2) Financial Statements and Schedules. See the Index to Financial Statements and Financial Statement Schedules on page F-1 of this Annual Report on Form 10-K.

(a) (3) Exhibits. See the Index to Exhibits on sequentially numbered page 14 of this Annual Report on Form 10-K.

(b) Reports on Form 8-K. No reports on Form 8-K were filed during the last quarter of the period covered by this Annual Report on Form 10-K.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned thereunto duly authorized.

THE DAVEY TREE EXPERT COMPANY

By: R. D. COWAN  
R. D. Cowan, Chairman, President and  
Chief Executive Officer

March 23, 1998

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report Form 10-K has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 23, 1998.

/s/ R. DOUGLAS COWAN  
R. DOUGLAS COWAN, Director;  
Chairman, President and Chief Executive Officer  
(Principal Executive and Operating Officer)

/s/ EUGENE W. HAUPT  
EUGENE W. HAUPT, Director

/s/ R. CARY BLAIR  
R. CARY BLAIR, Director

/s/ J. W. JOY  
J. W. JOY, Director

/s/ RICHARD E. DUNN  
RICHARD E. DUNN, Director

/s/ JAMES H. MILLER  
JAMES H. MILLER, Director

/s/ RUSSELL R. GIFFORD  
RUSSELL R. GIFFORD, Director

/s/ THOMAS G. MURDOUGH, JR.  
THOMAS G. MURDOUGH, JR., Director

/s/ WILLIAM D. GINN  
WILLIAM D. GINN, Director

/s/ DAVID E. ADANTE  
DAVID E. ADANTE, Executive Vice President,  
Chief Financial Officer and Secretary-Treasurer  
(Principal Financial Officer)

/s/ RICHARD S. GRAY  
RICHARD S. GRAY, Director

/s/ BRADLEY L. COMPORT  
BRADLEY L. COMPORT, Corporate Controller  
(Principal Accounting Officer)

## INDEX OF EXHIBITS

[Item 14(a) (3)]

		<b>LOCATION</b>
		<b>EXHIBIT NO. DESCRIPTION</b>
<b><u>SEQUENTIAL PAGE</u></b>		
(2)	Plan of acquisition, reorganization, arrangement, liquidation or succession.	Not Applicable.
(3)(i)	1991 Amended Articles of Incorporation	Incorporated by reference to Exhibit 3 (i) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1996.
(3)(ii)	1987 Amended and Restated Regulations of The Davey Tree Expert Company.	Incorporated by reference to Exhibit 3 (ii) to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1996.
(4)	Instruments defining the rights of security holders, including indentures	The Company is a party to certain instruments, copies of which will be furnished to the Securities and Exchange Commission upon request, defining the rights of holders of long-term debt identified in Note 5 of Notes to Consolidated Financial Statements on page F-14 of this Annual Report on Form 10-K.
(9)	Voting Trust Agreement	Not Applicable.
(10)(a)	1987 Incentive Stock Option Plan	16 - 19
(10)(b)	1994 Omnibus Stock Plan	Incorporated by reference to Exhibit 10 (c) to the Registrant's Form 10-Q for the quarter ended July 2, 1994.
(11)	Statement re computation of per share earnings	Not Applicable.
(12)	Statement re computation of ratios	Not Applicable.
(13)	Annual Report to security holders, Form 10-Q or quarterly report to security holders	Not Applicable.
(16)	Letter re change in certifying accountant	Not Applicable.
(18)	Letter re change in accounting principles	Not Applicable.

<u>EXHIBIT NO.</u>	<u>DESCRIPTION</u>	<u>LOCATION SEQUENTIAL PAGE</u>
(21)	Subsidiaries of the Registrant	20
(22)	Published report regarding matters submitted to vote of security holders	Incorporated by reference to Part II, Item 4 to the Registrant's Form 10-Q for the quarter ended June 28, 1997.
(23)	Consent of independent auditors to incorporation of their report in Registrant's Statements on Form S-8 (File Nos. 2-73052, 2-77353, 33-5755, 33-21072, and 33-59347) and Form S-2 (File No. 33-30970)	21
(24)	Power of Attorney	Not Applicable.
(27)	Financial Data Schedule	22

The documents listed as Exhibits 10(a) and 10(b) constitute management contracts or compensatory plans or arrangements.

~~---~~SIGNATURES


Pursuant to the requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned thereunto duly authorized.

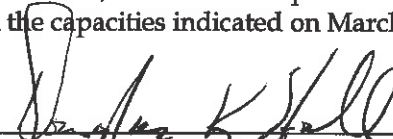
THE DAVEY TREE EXPERT COMPANY

By: \_\_\_\_\_  
R. D. Cowan, Chairman, President and  
Chief Executive Officer


March \_\_\_\_, 1999

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report Form 10-K has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 23, 1998.

  
\_\_\_\_\_  
R. DOUGLAS COWAN, Director;  
Chairman, President and Chief Executive Officer  
(Principal Executive and Operating Officer)

  
\_\_\_\_\_  
DOUGLAS K. HALL, Director

  
\_\_\_\_\_  
R. CARY BLAIR, Director

  
\_\_\_\_\_  
J. W. JOY, Director


  
\_\_\_\_\_  
RICHARD E. DUNN, Director

  
\_\_\_\_\_  
JAMES H. MILLER, Director

  
\_\_\_\_\_  
RUSSELL R. GIFFORD, Director

  
\_\_\_\_\_  
THOMAS G. MURDOUGH, JR., Director

  
\_\_\_\_\_  
WILLIAM D. GINN, Director

  
\_\_\_\_\_  
DAVID E. ADANTE, Executive Vice President,  
Chief Financial Officer and Secretary-Treasurer  
(Principal Financial Officer)

  
\_\_\_\_\_  
RICHARD S. GRAY, Director

  
\_\_\_\_\_  
BRADLEY L. COMFORT, Corporate Controller  
(Principal Accounting Officer)



## THE DAVEY TREE EXPERT COMPANY

## 1987 INCENTIVE STOCK OPTION PLAN

Plan Adopted by Board of Directors on April 20, 1987

Plan Approved by Shareholders on May 19, 1987

1. **Purpose.** This 1987 Incentive Stock Option Plan (the "Plan") is designed to promote the interest of the Company by enabling the Company, by grant of options to purchase Common Shares of the Company, to retain and attract key employees for the Company and its affiliates, and to provide additional incentive to those employees through increased stock ownership in the Company. Options granted under the Plan ("Options") shall be incentive stock options within the meaning of Section 422A of the Internal Revenue Code of 1986, as amended, as now in effect or as hereafter further amended (the "Code"). The term "affiliates" where used in the Plan means subsidiary corporations as defined in Section 425 of the Code.

2. **Administration.** The Plan shall be administered by the Compensation Committee of the Board of Directors of the Company (the "Committee"). The Committee shall have full power and authority to construe and interpret the provisions and to supervise the administration of the Plan, and to grant Options under the Plan. No Director who shall have been eligible within a period of one year prior to his appointment to the Committee to participate in the Plan or any other plan of the Company entitling participants therein to acquire shares, stock appreciation rights, or options of the Company is entitled to serve on the Committee. All decisions and designations made by the Committee pursuant to the provisions of the Plan shall be made by a majority of its members.

3. **Employees Who May Participate in the Plan.** Employees to whom options are granted shall be designated by the Committee. An Option may be granted to any full-time salaried key employee of the Company or of an affiliate, including any director or officer who is a key employee. An employee may hold more than one Option. No employee may, however, be granted incentive stock options under any and all stock option plans of the Company that become exercisable for the first time by the employee during any calendar year for shares that exceed an aggregate fair market value (determined on the date(s) of grant) of \$100,000.

4. **Shares Subject to the Plan.** The aggregate number of Common Shares that may be delivered upon the exercise of all Options granted under the Plan may not exceed 100,000, subject, however, to adjustment as provided in Section 13. The Common Shares to be issued under the Plan shall be the Company's authorized Common Shares and may be unissued shares or treasury shares as the Committee, with the concurrence of the Board of Directors, may from time to time determine. To the extent the Company shall reacquire Common Shares for such purposes, shares may be reacquired at the time Options are exercised, or from time to time in advance, whenever the Board of Directors may deem their purchase advisable. If an option is surrendered or for any other reason ceases to be exercisable in whole or in part, the Common Shares that are subject to the Option, but as to which the option has not been exercised, shall again become available for offering under the Plan, subject to the limitations contained in the first sentence of this Section 4.

5. **Option Grants.** Options granted under this Plan shall be deemed to be granted on the June 30 or December 31, whichever day occurs first, immediately preceding approval by the Committee of the granting of such Options.

**6. Option Price.** The Option price under each option shall be determined by the Committee or by the Board of Directors. The option price shall be not less than 100% of the fair market value of the Common Shares subject to the option on the date the option is granted, except that, if the optionee owns, at the time the Option is granted, shares possessing more than 10% of the total combined voting power of all classes of stock of the Company or of an affiliate, the Option price shall be not less than 110% of the fair market value of the shares on the date the option is granted. For purposes of the Plan, "fair market value" of shares shall be, with respect to options deemed to be granted on December 31, the fair market value established by the trustee of the Company's Employee Stock Ownership Trust ("ESOP Trustee") on that December 31, and with respect to options deemed to be granted on June 30, the fair market value established by the ESOP Trustee on that June 30.

**7. Notice of Grant of Option.** Promptly after the Committee grants any Option to an employee, the Committee shall cause the employee to be notified of the fact that the option has been granted and of the terms of the option.

**8. Exercise of Options.** No Option granted under the Plan may be exercised prior to the completion of one year of continuous employment with the Company or an affiliate after the date of grant, unless an option is accelerated as provided in Section 10(b), and under no circumstances later than the expiration date of the option. An option may be exercised only while the optionee is in the employ of the Company or an affiliate, except as otherwise provided in Section 9 or as may be permitted pursuant to substitute Options granted under Section 14. An option shall become exercisable at such time or times, in whole or in part, on a cumulative or non-cumulative basis, as the Committee may determine at the time the Option is granted. No fraction of a share may be purchased upon exercise of an Option.

**9. Exercise of Options After Termination of Employment.** Subject to the provision found in Section 8, that under no circumstances may an option be exercised later than the expiration date of the Option, an Option may be exercised after termination of the optionee's employment only in the following situations:

(a) If the termination of employment is due to retirement under the applicable retirement plan or policy of the Company or an affiliate, the optionee shall have the right within the period of three months next following the date of termination to purchase all or any part of the Common Shares that he would have been entitled to purchase if he had exercised his option on the date of termination.

(b) Upon the termination of employment of an optionee due to permanent and total disability or the death of an optionee while in the employ of the Company or a subsidiary or within the three-month period referred to in paragraphs (a) and (c) of this Section 9, the optionee or the optionee's estate, personal representative, or beneficiary shall have the right to exercise the Option in whole or in part within one year after the date of termination or the optionee's death.

(c) If the termination of employment is due to any reason other than the optionee's retirement as specified in (a) above or the optionee's permanent and total disability or death as specified in (b) above, the optionee may, provided the Committee or the Board of Directors consents, exercise the option in whole or in part within the period of three months after the date of termination of employment.

**10. Termination of Options.**

(a) An Option granted under the Plan shall terminate, and the right of the optionee (or his estate, personal representative, or beneficiary) to purchase shares upon exercise of the Option shall expire, on the date determined by the Committee at the time the option is granted. No Option, however, may have a life of more than ten years after the date on which it is granted, and, in the case of an optionee who owns, at the time the Option is granted, stock possessing more than 10% of the total combined voting power of all classes of stock of the Company or a subsidiary, no option may have a life of more than five years after the date on which it is granted.

(b) In the event of a proposed lease, sale, or other disposition of all or substantially all of the assets of the Company to other corporations, firms, or individuals or a proposed merger, consolidation, combination (as defined in Section 1701.01(Q), Ohio Revised Code), or majority share acquisition (as defined in Section 1701.01(R), Ohio Revised Code) involving the Company and as a result of which the holders of shares of the Company prior to the transaction would become, by reason of the transaction, the holders of such number of shares of the surviving or acquiring corporation as entitle them to exercise less than one-third of the voting power of the surviving or acquiring corporation in the election of directors, the Board of Directors of the Company may accelerate the date on which any outstanding Option or any portion of an outstanding Option becomes exercisable. If the Board of Directors so accelerates the date (i) the Board of Directors shall give the optionee written notice of the acceleration and the reasons therefor; (ii) the optionee may, not more than ten days prior to the anticipated effective date of the proposed transaction, exercise the Option to purchase any or all shares then subject to the Option; (iii) any such exercise shall be conditioned upon the consummation of the transaction and shall become effective immediately prior to the consummation date, in which event the employee need not make payment for the shares to be purchased upon exercise of the option until five days after written notice by the Company to the employee that the transaction has been consummated; (iv), if the proposed transaction is consummated, each Option, to the extent not previously exercised prior to the date specified in the foregoing notice, shall terminate on the effective date of the consummation, and (v), if the proposed transaction is abandoned, the shares then subject to the Option shall continue to be available for purchase in accordance with the other provisions of the Plan, and any acceleration of the date on which any outstanding Option, or part thereof, becomes exercisable shall be deemed to have been rescinded. In addition to the foregoing, the Committee may authorize the purchase by the Company, from the optionee, of options previously granted to any person who, at the time of any transaction described in the first sentence of this paragraph (b) of Section 10, is a director or officer of the Company for a price equal to the difference between the consideration per share payable pursuant to the terms of the transaction and the option price.

(c) If, at the meeting of shareholders of the Company next following the date on which the Board of Directors adopts the Plan, the shareholders do not approve the Plan, any Option theretofore granted shall, forthwith upon the final adjournment of the meeting of shareholders, become null and void.

**11. Notice of Exercise; Payment for Common Shares.** No certificate for Common Shares purchased upon exercise of an option shall be delivered until full payment of the purchase price for the Common Shares has been made. An employee to whom an option has been granted shall have none of the rights of a shareholder with respect to the Common Shares subject thereto until the Option is exercised by delivery of written notice of exercise to the Company. Following exercise of the Option, the employee shall have all of the rights of a shareholder with respect to the Common Shares purchased upon the exercise, except that he shall not have the right to vote the shares or to receive dividends with respect thereto until payment therefor has been made in full. Payment of the Option price must be made only in cash.

**12. Assignability.** Except as otherwise provided in Section 9(b), an Option granted under this Plan shall not be transferred and may be exercised only by the employee to whom granted. Each employee to whom an Option is granted, by accepting the Option, agrees with the Company that, in the event the Company merges into, consolidates with, or sells or otherwise transfers all or a substantial part of its assets to another corporation, he will consent to the assumption of the Option, or accept a new incentive stock option in substitution therefor, if the Committee or the Board of Directors requests him to do so and the option is not otherwise terminated in accordance with the provisions of Section 10(b).

**13. Adjustments Upon Changes in Shares.** In the event of any change in the Common Shares subject to the Plan or to any option granted under the Plan by reason of a merger, consolidation, reorganization, recapitalization, stock dividend, stock split-up, combination, or exchange of shares, or other change in the corporate structure of the Company, the aggregate number of shares as to which options may thereafter be granted under the Plan, the number of shares subject to each outstanding option, and the option price with respect to the shares shall be appropriately adjusted by the Board of Directors.

**14. Substitute Options.** The Board of Directors may grant Options in substitution for, or upon the assumption of, options granted by another corporation that is merged into, consolidated with, or all or a substantial part of the assets or stock of which is acquired by the Company or a subsidiary. Subject to the limit in Section 4 on the number of shares that may be delivered upon the exercise of options granted under the Plan, the terms and provisions of any options granted under this Section 14 may vary from the terms and provisions otherwise specified in the Plan and may, instead, correspond to the terms and provisions of the options granted by the other corporation.

**15. Purchase for Investment.** Each employee exercising an option may be required by the Company, in its sole discretion, to give a representation that he is acquiring the shares other than with a view to the distribution thereof. The Company may release any investment representation obtained if it subsequently determines that the representation is no longer required to insure that a sale or other disposition of the shares would not involve a violation of the provisions of the Securities Act of 1933, as amended, or of applicable state blue sky laws.

**16. Compliance with Securities Laws and Exchange Requirements.** No certificate for shares shall be delivered upon exercise of an Option until the Company shall have taken such action, if any, as is then required to comply with the provisions of the Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, the Ohio Securities Act, as amended, any applicable state blue sky laws, and with the requirements of any exchange on which the Common Shares may, at the time, be listed.

**17. Duration and Termination of the Plan.** The Plan shall remain in effect until April 20, 1997, and shall then terminate, unless terminated at an earlier date by action of the Board of Directors. Except as provided in Section 19, termination of the Plan shall not affect Options granted prior thereto.

**18. Amendment of the Plan.** The Board of Directors may alter or amend the Plan from time to time prior to its termination, except that, without shareholder approval, no amendment may increase the aggregate number of shares with respect to which Options may be granted (other than in accordance with the provisions of Section 13), reduce the option price at which options may be exercised (other than in accordance with the provisions of Section 13), extend the time within which options may be granted or exercised, or change the requirements relating to eligibility or to administration of the Plan. Except for adjustments made in accordance with the provisions of Section 13, the Board of Directors may not, without the consent of the holder of the Option, alter or impair any Option previously granted under the Plan.

**19. Shareholder Approval.** Approval of the Plan must be obtained by no later than June 30, 1987, by the affirmative vote of the holders of shares of the Company entitling them to exercise at least a majority of the voting power on the approval. Options may be granted prior to approval of the Plan by shareholders, but no option may be exercised until after the Plan has been approved by shareholders.

**SUBSIDIARIES OF THE REGISTRANT**

The Registrant has two wholly-owned subsidiaries, Davey Tree Surgery Company (incorporated in Ohio), and the Davey Tree Expert Co. of Canada, Limited (incorporated in Canada), each of which did business in 1997 under its corporate name.

**INDEPENDENT AUDITORS' CONSENT**

We consent to the incorporation by reference in Registration Statement Nos. 2-73052, as amended, 2-77353, 33-5755, 33-21072 and 33-59347 on Forms S-8 relating to The Davey Tree Expert Company 1980 Employee Stock Option Plan, The Davey Tree Expert Company 1982 Employee Stock Option Plan, The Davey Tree Expert Company 1985 Incentive Stock Option Plan, The Davey Tree Expert Company 1987 Incentive Stock Option Plan and The Davey Tree Expert Company 1994 Omnibus Stock Plan, and in Registration Statement No. 33-30970 on Form S-2 relating to The Davey Tree Expert Company 1989 Stock Subscription Plan and in the related prospectus, of our report dated February 13, 1998 appearing in this Annual Report on Form 10-K of The Davey Tree Expert Company for the year ended December 31, 1997.

/s/DELOITTE & TOUCHE LLP

Cleveland, Ohio  
March 23, 1998

**Financial Data Schedule**

**INDEX TO FINANCIAL STATEMENTS  
AND FINANCIAL STATEMENT SCHEDULES  
[Items 14(a)(1) and (2)]**

<b><u>Description</u></b>	<b><u>Page</u></b>
Independent Auditors' Report	F-2
Consolidated Balance Sheets as of December 31, 1997, 1996 and 1995	F-3
Consolidated Statements of Net Earnings for the years ended December 31, 1997, 1996 and 1995	F-5
Consolidated Statements of Shareholders' Equity for the years ended December 31, 1997, 1996 and 1995	F-6
Consolidated Statements of Cash Flows for the years ended December 31, 1997, 1996 and 1995	F-8
Notes to Consolidated Financial Statements for the years ended December 31, 1997, 1996 and 1995	F-9



## ***INDEPENDENT AUDITORS' REPORT***

To the Shareholders and Board of Directors  
The Davey Tree Expert Company  
Kent, Ohio

We have audited the accompanying consolidated balance sheets of The Davey Tree Expert Company and subsidiary companies as of December 31, 1997, 1996, and 1995, and the related consolidated statements of net earnings, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of The Davey Tree Expert Company and subsidiary companies as of December 31, 1997, 1996, and 1995, and the results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

/s/ DELOITTE & TOUCHE LLP

Cleveland, Ohio  
February 13, 1998

**THE DAVEY TREE EXPERT COMPANY AND SUBSIDIARY COMPANIES**

**CONSOLIDATED BALANCE SHEETS**

	1997	December 31 1996	1995
	<i>(Dollars in Thousands)</i>		
<b>ASSETS</b>			
<i>CURRENT ASSETS:</i>			
Cash and cash equivalents	\$ 722	\$ 627	\$ 1,470
Accounts receivable	43,896	39,805	34,622
Operating supplies	2,662	2,477	2,136
Prepaid expenses and other assets	2,724	2,023	1,791
Deferred income taxes	<u>2,032</u>	<u>1,786</u>	<u>2,697</u>
Total current assets	52,036	46,718	42,716
<i>PROPERTY AND EQUIPMENT:</i>			
Land and land improvements	6,283	6,178	6,446
Buildings and leasehold improvements	16,142	16,682	15,956
Equipment	<u>166,902</u>	<u>148,204</u>	<u>139,711</u>
	189,327	171,064	162,113
Less accumulated depreciation	<u>123,053</u>	<u>113,980</u>	<u>107,977</u>
Net property and equipment	66,274	57,084	54,136
<i>OTHER ASSETS AND INTANGIBLES</i>	9,515	7,584	7,309
	<hr/>	<hr/>	<hr/>
<b>TOTAL ASSETS</b>	<b><u>\$127,825</u></b>	<b><u>\$111,386</u></b>	<b><u>\$104,161</u></b>

See notes to consolidated financial statements.

	1997	December 31 1996	1995
	<i>(Dollars in Thousands)</i>		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>			
<i>CURRENT LIABILITIES:</i>			
Accounts payable	\$ 10,187	\$ 10,174	\$ 8,488
Accrued liabilities	10,822	8,229	8,592
Insurance liabilities	6,738	6,105	6,791
Income taxes payable	1,647	218	3,171
Notes payable, bank	300	75	400
Current maturities of long-term debt	<u>3,148</u>	<u>2,634</u>	<u>2,781</u>
Total current liabilities	32,842	27,435	30,223
<i>LONG-TERM DEBT</i>	24,104	19,640	17,049
<i>DEFERRED INCOME TAXES</i>	1,381	1,952	3,182
<i>INSURANCE LIABILITIES</i>	10,913	9,007	6,380
<i>OTHER LIABILITIES</i>	<u>698</u>	<u>882</u>	<u>797</u>
<i>TOTAL LIABILITIES</i>	69,938	58,916	57,631
<i>SHAREHOLDERS' EQUITY:</i>			
Preferred shares			
Common shares	8,728	8,728	8,728
Additional paid-in capital	4,625	3,876	3,472
Retained earnings	<u>84,975</u>	<u>75,324</u>	<u>67,922</u>
	98,328	87,928	80,122
<i>LESS:</i>			
Treasury shares, at cost	40,441	35,451	33,198
Subscriptions receivable from employees		7	297
Future contributions to ESOT	<u>          </u>	<u>          </u>	<u>97</u>
<i>TOTAL SHAREHOLDERS' EQUITY</i>	<u>57,887</u>	<u>52,470</u>	<u>46,530</u>
<i>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</i>	<u>\$127,825</u>	<u>\$111,386</u>	<u>\$104,161</u>

See notes to consolidated financial statements.

# THE DAVEY TREE EXPERT COMPANY AND SUBSIDIARY COMPANIES

## CONSOLIDATED STATEMENTS OF NET EARNINGS

	Years Ended December 31					
	1997		1996		1995	
	<i>(Dollars in Thousands, Except Per Share Amounts)</i>					
<i>REVENUES</i>	\$ 295,079	100.0%	\$ 266,934	100.0%	\$ 229,682	100.0%
<i>COSTS AND EXPENSES:</i>						
Operating	197,726	67.0	183,427	68.7	159,310	69.4
Selling	37,832	12.8	33,575	12.6	28,629	12.5
General and administrative	20,297	6.9	18,216	6.8	15,889	6.9
Depreciation and amortization	<u>17,375</u>	<u>5.9</u>	<u>14,690</u>	<u>5.5</u>	<u>13,201</u>	<u>5.7</u>
	<u>273,230</u>	<u>92.6</u>	<u>249,908</u>	<u>93.6</u>	<u>217,029</u>	<u>94.5</u>
<i>EARNINGS FROM OPERATIONS</i>	21,849	7.4	17,026	6.4	12,653	5.5
<i>INTEREST EXPENSE</i>	2,703	.9	2,457	.9	2,725	1.2
<i>OTHER INCOME - NET</i>	<u>(105)</u>		<u>(272)</u>	<u>(.1)</u>	<u>(183)</u>	<u>(.1)</u>
<i>EARNINGS BEFORE INCOME TAXES</i>	19,251	6.5	14,841	5.6	10,111	4.4
<i>INCOME TAXES</i>	<u>7,972</u>	<u>2.7</u>	<u>6,082</u>	<u>2.3</u>	<u>3,974</u>	<u>1.7</u>
<i>EARNINGS FROM CONTINUING OPERATIONS</i>	11,279	3.8	8,759	3.3	6,137	2.7
<i>DISCONTINUED OPERATION - NET EARNINGS</i>					<u>236</u>	<u>.1</u>
<i>NET EARNINGS</i>	<u>\$ 11,279</u>	<u>3.8%</u>	<u>\$ 8,759</u>	<u>3.3%</u>	<u>\$ 6,373</u>	<u>2.8%</u>
<i>EARNINGS PER COMMON SHARE:</i>						
<i>FROM CONTINUING OPERATIONS</i>	<u>\$ 2.57</u>		<u>\$ 1.92</u>		<u>\$ 1.29</u>	
NET EARNINGS	<u>\$ 2.57</u>		<u>\$ 1.92</u>		<u>\$ 1.34</u>	
<i>EARNINGS PER COMMON SHARE - ASSUMING DILUTION:</i>						
<i>FROM CONTINUING OPERATIONS</i>	<u>\$ 2.39</u>		<u>\$ 1.86</u>		<u>\$ 1.27</u>	
NET EARNINGS	<u>\$ 2.39</u>		<u>\$ 1.86</u>		<u>\$ 1.32</u>	

See notes to consolidated financial statements.

**THE DAVEY TREE EXPERT COMPANY AND SUBSIDIARY COMPANIES**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
YEARS ENDED DECEMBER 31, 1997, 1996 AND 1995  
(Dollars in Thousands, Except Per Share Amounts)**

	Common Shares	Additional Paid-In Capital
<i>BALANCE, JANUARY 1, 1995</i>	\$ 8,728	\$ 3,167
Receipts from subscriptions receivable		
Shares purchased		
Shares sold to employees		281
Options exercised		24
Contributions to ESOT		
Net earnings		
Dividends, \$.275 per share		
Net adjustment for foreign currency translation		
	<hr/>	<hr/>
<i>BALANCE, DECEMBER 31, 1995</i>	8,728	3,472
Receipts from subscriptions receivable		
Shares purchased		
Shares sold to employees		373
Options exercised		31
Contributions to ESOT		
Net earnings		
Dividends, \$.295 per share		
Net adjustment for foreign currency translation		
	<hr/>	<hr/>
<i>BALANCE, DECEMBER 31, 1996</i>	8,728	3,876
Receipts from subscriptions receivable		
Shares purchased		
Shares sold to employees		695
Options exercised		54
Net earnings		
Dividends, \$.34 per share		
Net adjustment for foreign currency translation		
	<hr/>	<hr/>
<i>BALANCE, DECEMBER 31, 1997</i>	<u>\$ 8,728</u>	<u>\$ 4,625</u>

See notes to consolidated financial statements.

<b>Retained Earnings</b>	<b>Treasury Shares</b>	<b>Subscriptions Receivable From Employees</b>	<b>Contributions To ESOT</b>	<b>Total</b>
\$ 62,851	\$ (29,416)	\$ (606)	\$ (193)	\$ 44,531
		309		309
	(4,853)			(4,853)
	953			1,234
	118			142
			96	96
6,373				6,373
(1,292)				(1,292)
<u>(10)</u>				<u>(10)</u>
67,922	(33,198)	(297)	(97)	46,530
		290		290
	(3,045)			(3,045)
	716			1,089
	76			107
			97	97
8,759				8,759
(1,341)				(1,341)
<u>(16)</u>				<u>(16)</u>
75,324	(35,451)	(7)	0	52,470
		7		7
	(5,918)			(5,918)
	737			1,432
	191			245
11,279				11,279
(1,494)				(1,494)
<u>(134)</u>				<u>(134)</u>
<u>\$ 84,975</u>	<u>\$ (40,441)</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 57,887</u>

See notes to consolidated financial statements.

# THE DAVEY TREE EXPERT COMPANY AND SUBSIDIARY COMPANIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31		
	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net earnings	\$ 11,279	\$ 8,759	\$ 6,373
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation	17,000	14,338	12,827
Amortization	375	352	374
Deferred income taxes	(817)	(319)	(873)
Other	<u>(326)</u>	<u>(273)</u>	<u>(834)</u>
	27,511	22,857	17,867
Change in operating assets and liabilities:			
Accounts receivable	(4,091)	(5,183)	(5,309)
Other assets	(2,876)	(966)	47
Accounts payable and accrued liabilities	2,606	1,323	1,664
Insurance liabilities	2,539	1,941	4,778
Other liabilities	<u>1,245</u>	<u>(2,868)</u>	<u>2,145</u>
Net cash provided by operating activities	<u>26,934</u>	<u>17,104</u>	<u>21,192</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Proceeds from sales of property and equipment	1,138	1,678	898
Acquisitions	(449)	(820)	(395)
Proceeds from sale of business			1,300
Capital expenditures:			
Land and buildings	(285)	(727)	(504)
Equipment	<u>(26,718)</u>	<u>(17,394)</u>	<u>(12,793)</u>
Net cash used in investing activities	<u>(26,314)</u>	<u>(17,263)</u>	<u>(11,494)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net borrowings (payments) under notes payable, bank	225	(325)	301
Principal payments of long-term debt	(2,778)	(2,704)	(7,162)
Proceeds from issuance of long-term debt	7,756	5,148	2,024
Sales of treasury shares	1,677	1,196	1,376
Receipts from stock subscriptions	7	290	309
ESOT payment of debt guaranteed by Company		97	96
Dividends paid	(1,494)	(1,341)	(1,292)
Repurchase of common shares	<u>(5,918)</u>	<u>(3,045)</u>	<u>(4,853)</u>
Net cash used in financing activities	<u>(525)</u>	<u>(684)</u>	<u>(9,201)</u>
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	95	(843)	497
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>	<u>627</u>	<u>1,470</u>	<u>973</u>
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<u>\$ 722</u>	<u>\$ 627</u>	<u>\$ 1,470</u>

See notes to consolidated financial statements.

# **THE DAVEY TREE EXPERT COMPANY AND SUBSIDIARY COMPANIES**

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

### **THREE YEARS ENDED DECEMBER 31, 1997**

---

#### **1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### ***Nature of Operations***

The Company provides a broad line of horticultural services to corporate, institutional and residential customers throughout most of the United States and Canada.

##### ***Principles of Consolidation***

The consolidated financial statements include the accounts of The Davey Tree Expert Company and its subsidiary companies. All significant intercompany accounts and transactions have been eliminated in consolidation.

##### ***Use of Estimates***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

##### ***Fiscal Year***

The Company's fiscal year ends on the Saturday closest to December 31; 1997 was a 53 week year ended January 3, 1998. In 1996 and 1995, the fiscal years were each comprised of 52 weeks ended December 28, 1996, and December 30, 1995, respectively. For presentation purposes, all years were presumed to have ended on December 31.

##### ***Revenue Recognition***

The Company recognizes revenues as services are provided, either on a time and materials basis, price per unit completed, or an agreed upon fee for services performed.

##### ***Cash and Cash Equivalents, Accounts Receivable and Accounts Payable***

Carrying amounts approximate fair value due to the short maturity of these instruments. Cash equivalents are highly liquid investments with maturities of three months or less when purchased. Due to the short maturities, the carrying amount of the investments approximates fair value.

##### ***Accounts Receivable***

The Company had allowances of \$314,000 at December 31, 1997 and 1996, and \$330,000 at December 31, 1995.

##### ***Intangible Assets***

Intangible assets represent goodwill, employment contracts, client lists and similar assets resulting from business acquisitions and are being amortized on a straight-line basis over their estimated useful lives ranging from 3 to 20 years.

##### ***Property and Equipment***

The Company records property and equipment at cost. Generally, land improvements, leasehold improvements and buildings are depreciated by the straight-line method while the declining balance method is used for equipment. The estimated useful lives used in computing depreciation are: land improvements, 5-20 years; buildings and leasehold improvements, 5-40 years; equipment, 3-10 years.



1. **SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

**Earnings Per Share**

In 1997, the Financial Accounting Standards Board (FASB) issued Statement of Financial Standards (SFAS) No. 128, "Earnings Per Share." This standard replaces the calculation of primary and fully diluted earnings per share with basic and diluted earnings per share. Unlike the Company's previously reported primary earnings per share, basic earnings per share excludes the dilutive effects of options; diluted earnings per share includes their effect. All earnings per share amounts for all periods have been presented, and where appropriate, restated to conform to the new standard.

The following table sets forth the computation of earnings per common share and earnings per common share – assuming dilution:

	<u>1997</u>	<u>1996</u>	<u>1995</u>
<i>(Dollars in Thousands, Except Per Share Amounts)</i>			
Numerator:			
Earnings from continuing operations	\$ 11,279	\$ 8,759	\$ 6,137
Discontinued operations – net earnings			236
Net earnings	<u>\$ 11,279</u>	<u>\$ 8,759</u>	<u>\$ 6,373</u>
Denominator:			
For earnings per common share			
weighted average shares outstanding	4,392,969	4,550,677	4,750,024
Effect of dilutive securities			
employee and director stock options	<u>332,837</u>	<u>163,930</u>	<u>63,514</u>
Denominator for earnings per share – assuming dilution	<u>4,725,806</u>	<u>4,714,607</u>	<u>4,813,538</u>
Earnings per common share:			
From continuing operations	\$ 2.57	\$ 1.92	\$ 1.29
Discontinued operations – net earnings			.05
Net earnings	<u>\$ 2.57</u>	<u>\$ 1.92</u>	<u>\$ 1.34</u>
Earnings per common share – assuming dilution:			
From continuing operations	\$ 2.39	\$ 1.86	\$ 1.27
Discontinued operations – net earnings			.05
Net earnings	<u>\$ 2.39</u>	<u>\$ 1.86</u>	<u>\$ 1.32</u>
Antidilutive shares not included in earnings per common share – assuming dilution			
	<u>0</u>	<u>20,402</u>	<u>31,746</u>

**Stock Split**

The Company's board of directors declared a 2 for 1 stock split on September 27, 1996. The additional shares as a result of the split were distributed on October 10, 1996 to shareholders of record as of October 1, 1996. Common shares issued, treasury shares, and per common share amounts have been restated for all periods presented to give retroactive effect to the stock split.

## **1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

### ***Recently Issued Accounting Standards***

In 1997, the FASB issued SFAS No. 130, "Reporting Comprehensive Income." This statement establishes standards for reporting and display of comprehensive income and its components in a full set of general-purpose financial statements, but does not address either issues of recognition or measurement. It is effective for the Company in 1998. The only item that will impact the Company's display of comprehensive income will be net adjustments for foreign currency translation, which have previously been reported within the statement of shareholders' equity.

In 1997, the FASB also issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information." It becomes effective in 1998 and requires that public business enterprises report certain information about operating segments in complete sets of financial statements of the enterprise and in condensed financial statements of interim periods issued to shareholders, as well as other information regarding products and services, geographic information, and major customers. The Company has not yet completed its analysis of SFAS No. 131 and accordingly has yet to determine the effect, if any, it will have on future financial statement disclosures.

### ***Reclassifications***

Reclassifications have been made to the prior-year financial statements to conform to the current year presentation.

## **2. INSURANCE LIABILITIES**

In managing its casualty liability exposures for workers compensation, auto liability, and general liability, the Company is substantially self-insured. It generally retains the first \$300,000 in loss per occurrence and carries excess insurance above that amount. With respect to workers compensation, the Company's risk of exposure to loss per occurrence may be less than \$300,000 depending on the nature of the claim and the statutes in effect by state.

Insurance liabilities are determined using actuarial methods and assumptions to estimate ultimate costs. They include a large number of claims for which the ultimate costs will develop over a period of several years. Accordingly, the estimates can change as claims mature; they can also be affected by changes in the number of new claims incurred and claim severity. For these reasons, it is possible that these estimates can change materially in the near term. Changes in estimates of claim costs resulting from new information received will be recognized in income in the period in which the estimates are changed. Expenses that are unallocable to specific claims are recognized as period costs.

These liabilities, including the present value of workers compensation liabilities which are discounted at 5 ¾ % at December 31, 1997, 6 ¼ % at December 31, 1996, and 5 ½ % at December 31, 1995, totaled \$17,651,000, \$15,112,000 and \$13,171,000 at December 31, 1997, December 31, 1996, and December 31, 1995, respectively. The increases in 1997 and 1996 resulted from an additional year's exposure to self-insured claims as well as their continued maturation. The change in the discount rate increased insurance costs by approximately \$213,000 in 1997. Insurance liabilities are classified as current and noncurrent liabilities based on the timing of future estimated cash payments. At December 31, 1997, 1996, and 1995, the gross value of those liabilities was approximately \$20,765,000, \$18,740,000 and \$16,911,000, respectively.

### 3. COMMON AND PREFERRED SHARES

The Company has authorized a class of 4,000,000 preferred shares, no par value, of which none were issued.

The number of common shares authorized is 12,000,000, par value \$1.00. At December 31, 1997, 1996 and 1995, the number of common shares issued was 8,728,440 and the number of shares in the treasury were 4,429,205, 4,209,623, and 4,104,976, respectively.

The Company's stock is not listed or traded on an active stock market and market prices are, therefore, not available. Semi-annually, an independent stock valuation firm determines the fair market value based upon the Company's performance and financial condition.

Since 1979, the Company has provided a ready market for all shareholders through its direct purchase of their common shares. During 1997, these purchases totaled 324,124 shares for \$5,918,000 in cash; the Company also had direct sales, to directors and employees, excluding those shares sold through either the exercise of options or the employee stock purchase plan below, of 12,264 shares for \$220,000. It also sold 8,420 shares to the Company's 401 (k) plan for \$169,000. Uniform restrictions apply to the transfer of the Company's common shares. These restrictions generally give the Company or the trust of the Company's Employee Stock Ownership Plan the right to purchase the common shares whenever a shareholder proposes to transfer the shares to anyone, other than transfers to a current employee of the Company or transfers by a current or former employee to members of their immediate family.

#### *Stock-Based Compensation Plans*

The 1994 Omnibus Stock Plan consolidated into a single plan provisions for the grant of stock options and other stock based incentives and maintenance of the employee stock purchase plan. Other than director options, the grant of awards is at the discretion of the compensation committee of the board of directors. The aggregate number of common shares available for grant and the maximum number of shares granted annually are based on formulas defined in the plan. Each non-employee director elected or appointed, and re-elected or re-appointed, will receive a director option that gives the right to purchase, for six years, 2,000 common shares at the fair market value per share at date of grant. The director options are exercisable six months from the date of grant. The maximum number of shares that may be issued upon exercise of stock options, other than director options and nonqualified stock options, is 800,000 during the ten year term of the plan.

Shares available for grant at December 31, 1997 were 176,704, which were based on the number available upon ratification of the plan less: the options granted presented below; the director options granted; and 329,330 shares purchased since 1994 under the stock purchase plan.

A summary of the status of the Company's director options as of December 31, 1997, 1996, and 1995, and changes during the years ending on those dates is presented below:

	1997		1996		1995	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	24,000	\$14.06	24,000	\$14.16	20,000	\$14.82
Granted	10,000	18.79	2,000	13.56	6,000	12.19
Exercised	(4,000)	13.51	(2,000)	14.82		
Forfeited					(2,000)	14.82
Outstanding at end of year	<u>30,000</u>	15.71	<u>24,000</u>	14.06	<u>24,000</u>	14.16

The Company has an employee stock purchase plan that provides the opportunity for all full-time employees with one year of service to purchase shares through payroll deductions. The purchase price for the shares offered under the plan is 85% of the fair value of the shares.

### 3. COMMON AND PREFERRED SHARES (Continued)

Purchases under the plan have been as follows:

	<u>1997</u>	<u>1996</u>	<u>1995</u>
Number of employees participating	817	787	772
Annual shares purchased	62,108	80,006	90,798
Average price paid	\$16.63	\$12.44	\$10.49
Cumulative shares purchased	1,484,282	1,422,174	1,342,168

Prior to adoption of the 1994 Omnibus Stock Plan, the Company had two qualified stock option plans available for officers and management employees; the final grant of awards under those plans was December 10, 1993.

A summary of the status of the Company's stock option plans, excluding director options, as of December 31, 1997, 1996, and 1995, and changes during the years ending on those dates is presented below:

<b>Fixed Options</b>	<u>1997</u>		<u>1996</u>		<u>1995</u>	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding at beginning of year	965,600	\$12.97	708,800	\$ 11.88	763,670	\$ 11.88
Granted			265,000	15.80		
Exercised	(17,750)	10.82	(8,200)	10.56	(16,670)	9.40
Forfeited					(38,200)	12.90
Outstanding at end of year	<u>947,850</u>	13.01	<u>965,600</u>	12.97	<u>708,800</u>	11.88
Options exercisable at year end	735,850		646,600		492,800	
Weighted average fair value of options granted during the year	--		\$ 2.65		-	

The following table summarizes information about fixed stock options outstanding at December 31, 1997:

<u>Exercise Price</u>	<u>Options Outstanding</u>		<u>Number Exercisable at 12/31/97</u>
	<u>Number Outstanding at 12/31/97</u>	<u>Remaining Contractual Life</u>	
\$ 9.40	210,500	2.0 years	210,500
11.89	25,850	5.0	25,850
12.44	230,500	4.3	230,500
13.83	216,000	6.0	216,000
15.80	<u>265,000</u>	8.9	<u>53,000</u>
	<u>947,850</u>		<u>735,850</u>

The Company continues to apply the intrinsic-value method under APB Opinion 25 and related interpretations in accounting for awards granted under the three plans. Using this method, compensation is measured as the difference between the option exercise price and the market value of the stock at the date of grant. Accordingly, no compensation cost has been recognized for either the fixed options granted under these plans or the employee stock purchase plan. Had compensation cost for the Company's stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net earnings and earnings per common share - assuming dilution would have been reduced by \$330,000 and \$.07 in 1997, \$201,000 and \$.04 in 1996 and \$180,000 and \$.04 in 1995.

### 3. COMMON AND PREFERRED SHARES (Continued)

In calculating the pro forma impact on earnings, the following assumptions were used for the grants in 1996: initial annual dividends of \$.31 per share with annual increases of \$.02 per share; a risk free interest rate of 6.25%; an expected life of 5 years; and an estimated forfeiture rate of 8%. The 1996 options vest at the rate of 20% annually. The pro forma amounts for 1997, 1996, and 1995 include \$200,000, \$190,000 and \$180,000, respectively, attributable to compensation cost for shares acquired under the employee stock purchase plan.

#### *Stock Subscription Offering*

In 1989, the Company made a stock subscription offering to employees and directors whereby they could subscribe to purchase stock for \$7.93 per share. Employees could purchase the Company's common shares by making a 10% cash down payment and financing the remainder of the balance with seven-year promissory notes payable to the Company through monthly payroll deductions or annual installments commencing in September, 1989. The notes called for interest at a rate of 8% per annum and have been reflected as subscriptions receivable in shareholders' equity. A total of 141 participants subscribed for 457,752 common shares of the Company.

### 4. ACCRUED LIABILITIES

Accrued liabilities consisted of:

	December 31		
	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
Compensation	\$ 5,648	\$ 4,009	\$ 3,521
Medical claims	1,948	1,390	1,430
Vacation	1,848	1,620	1,658
Taxes, other than taxes on income	657	600	607
Other	<u>721</u>	<u>610</u>	<u>1,376</u>
	<u>\$ 10,822</u>	<u>\$ 8,229</u>	<u>\$ 8,592</u>

### 5. NOTES PAYABLE, BANK AND LONG-TERM DEBT

#### *Notes Payable, Bank*

The Company has a bank operating loan which is repayable on demand and charges interest at the bank's prime rate. Additionally, the Company has unused short-term lines of credit with three banks totaling \$3,702,000, generally at the banks' prime rate, which was 8.5 % at December 31, 1997.

5. **NOTES PAYABLE, BANK AND LONG-TERM DEBT (Continued)**

**Long-Term Debt**

	December 31		
	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
Revolving credit agreement:			
Prime rate borrowings	\$ 2,800	\$ 3,100	\$ 2,900
London Interbank Offered Rate (LIBOR) borrowings	18,000	11,000	6,000
Term note agreement	<u>4,800</u>	<u>7,200</u>	<u>9,600</u>
	25,600	21,300	18,500
Long-term debt of ESOT			97
Subordinated notes - stock redemption	357	515	673
Term loans and other	<u>1,295</u>	<u>459</u>	<u>560</u>
	27,252	22,274	19,830
Less current maturities	<u>3,148</u>	<u>2,634</u>	<u>2,781</u>
	<u>\$ 24,104</u>	<u>\$ 19,640</u>	<u>\$ 17,049</u>

The total annual installments required to be paid on long-term debt are as follows: 1998, \$3,148,000; 1999, \$2,867,000; 2000, \$155,000; 2001, \$40,000; 2002, \$39,000; and thereafter \$203,000. The revolving credit agreement is classified as long-term debt and excluded from these installments since it is expected that these amounts will be outstanding throughout the ensuing year.

**Revolving Credit Agreement**

The Company has a Revolving Credit Agreement (Revolver) with two banks, which permits borrowings, as defined, up to \$35,000,000. It provides the Company an option of borrowing funds at either the prime (8.5% at December 31, 1997) interest rate or rates based on LIBOR (5.75% at December 31, 1997), plus a margin adjustment ranging from .7% to 1.0%. The Revolver also includes a commitment fee of 3/16 of 1% on the average daily unborrowed commitment. Borrowings may be converted, at the Company's option, to four-year loans. The agreement has an expiration date of April 30, 2000, and provides for one year extensions beyond that date annually.

On May 16, 1997, the Company obtained a temporary line of credit in the amount of \$5,000,000 with its principal bank which provided for borrowings at either the prime interest rate, rates based on LIBOR, or a negotiated fixed interest rate. The agreement has an expiration date of April 30, 1998.

Under the most restrictive covenants of the Revolver and the Term Note Agreement ("Term Note") below, the Company is obligated to maintain a minimum shareholders' equity, as defined, of \$38,000,000 plus 30% of annual consolidated earnings from December 31, 1996; a maximum ratio of consolidated funded debt to consolidated net worth of .45 to 1; and a fixed charge coverage ratio of not less than 2.25 to 1.0.

**Term Note Agreement**

In 1992 the Company borrowed \$12,000,000 under the Term Note which provides for twenty consecutive quarterly principal installments of \$600,000 commencing January 1, 1995 plus interest at either LIBOR plus 1-5/16% or prime plus 1/4%. The average adjusted LIBOR rate during 1997 was 7.06%; adjusted LIBOR was 7.09 %, 6.96%, and 5.63% at December 31, 1997, 1996 and 1995, respectively.

5. **NOTES PAYABLE, BANK AND LONG-TERM DEBT (Continued)**

**Long-Term Debt of ESOT**

Commencing March 31, 1992, the agreement provided for twenty equal quarterly installments of \$24,098 plus interest of 8.4% with the final installment due December 31, 1996.

**Subordinated Notes**

In 1995, 1992, and 1990, the Company redeemed shares of its common stock from shareholders for cash and five-year subordinated promissory notes bearing interest at a rate equal to the average of the prime rate and the prevailing local bank basic savings rate, which was 5.3% in 1997. There were 31,574 shares redeemed in 1995 for cash of \$174,147 and notes of \$595,627. In 1992, 16,800 shares were redeemed for cash of \$223,830 and notes of \$193,986. In 1990, 32,937 shares were redeemed for cash of \$179,730 and notes of \$478,022.

**Term Loans and Other**

The weighted average interest on the term loans approximates 8.78 % and the amounts outstanding are being repaid primarily in equal monthly installments through 2007.

**Interest on Debt**

The Company made cash payments for interest on all debt of \$2,806,000, \$2,475,000, and \$2,732,000 in 1997, 1996, and 1995, respectively.

6. **FINANCIAL INSTRUMENTS**

The Company has used interest rate exchange agreements (swaps) with its principal bank to modify the interest rate characteristics on its borrowings under the variable interest rate Term Note. Management's authority to utilize these agreements is restricted by the Board of Directors, and they are not used for trading purposes. At December 31, 1997, 1996, and 1995, the outstanding swaps had a total notional amount of \$4,800,000, \$7,200,000, and \$9,600,000, which effectively changes the interest rate exposure on the Term Note to a fixed 7.22% over the same maturity period. On December 16, 1993, a "reverse" swap was entered into which effectively changed the fixed interest rate on one-half of the Term Note to a variable rate for two years.

The swaps are accounted for using the settlement method or the "matched swap" method in which the quarterly net cash settlements of the agreements are recognized in interest expense when they accrue. The accrual amounts are included in the consolidated balance sheets as accrued liabilities. Interest expense was increased by \$9,000, \$25,000, and \$80,000 in 1997, 1996 and 1995 respectively from these agreements. An interest rate swap is considered to be a matched swap if it is linked through designation with an asset or liability provided that it has the opposite interest rate characteristics of the asset or liability. Generally, if the asset or liability that is linked to the swap matures, or is extinguished, or if the swap no longer qualifies for settlement accounting the swap will be marked to market through income. The term of the agreements is matched with the maturity period of the Term Note. If the Company decided to terminate the swap agreements any resulting gain or loss would be deferred and amortized over the original life of the swap contracts or recognized with the offsetting gain or loss of the hedged transaction.

The fair value of the swaps is the quoted amount that the Company would receive or pay to terminate the swap agreements as provided by the bank, taking into account current interest rates. Had these agreements been terminated as of December 31 each year, the Company would have paid \$3,000, received \$1,000 and paid \$50,000 in 1997, 1996, and 1995, respectively.

The carrying value of the Company's long-term debt is considered to approximate fair value based on borrowing rates currently available for loans with similar terms and maturities.

## 7. EMPLOYEE STOCK OWNERSHIP PLAN AND 401KSOP

On March 15, 1979, the Company consummated a plan which transferred control of the Company to its employees. As a part of this plan, the Company sold 2,880,000 common shares to the Company's Employee Stock Ownership Trust (ESOT) for \$2,700,000.

The Employee Stock Ownership Plan, in conjunction with the related trust (ESOT), provided for the grant to certain employees of certain ownership rights in, but not possession of, the common shares held by the trustee of the Trust. Annual allocations of shares have been made to individual accounts established for the benefit of the participants.

The Employee Stock Ownership Plan included as participants, all nonbargaining employees of the parent company and its domestic subsidiaries who have attained age 21 and completed one year of service.

Statement of Position 93-6 "Employers Accounting for Employee Stock Ownership Plans" requires the employer to recognize compensation expense equal to the fair value of the shares committed to be released; however, it allows an employer with an ESOP holding shares purchased prior to December 31, 1992 to continue their existing accounting treatment. Accordingly, the Company has elected to maintain its existing accounting treatment.

The number of shares released from collateral and available for allocation to ESOP participants was determined by dividing the sum of the current year loan principal and interest payments by the sum of the current and future years' loan principal and interest payments. The Company made annual cash contributions to the ESOP, net of dividends paid on the shares held as collateral, sufficient to pay the principal and interest on the ESOT debt; such contributions are reflected as an expense of the Company. Dividends on allocated shares are credited to participants' accounts and charged against retained earnings. ESOP shares that have been released and committed to be released are considered outstanding for purposes of computing earnings per share.

The contributions to the ESOT were:

	1996	1995
	<i>(Dollars in Thousands)</i>	
Principal repayment	\$ 97	\$ 96
Interest	<u>5</u>	<u>14</u>
Total cash contributions required	102	110
Less dividends paid on collateral shares	<u>12</u>	<u>23</u>
ESOT expense	<u>\$ 90</u>	<u>\$ 87</u>
Annual release of shares from collateral	<u>38,970</u>	<u>42,216</u>
Cumulative release of shares from collateral	<u>2,880,000</u>	<u>2,841,030</u>
Number of shares remaining in collateral	<u>0</u>	<u>38,970</u>

Effective January 1, 1997, the Company commenced operation of the "The Davey 401KSOP and ESOP," which retained the existing ESOP participant accounts and incorporated a deferred savings plan (401(k) plan) feature. Participants in the plan are allowed to make before-tax contributions, within Internal Revenue Service established limits, through payroll deductions. The Company will match, in either cash or Company stock, 50% of each participant's before-tax contribution, limited to the first 3% of the employee's compensation deferred each year. Eligibility to participate is the same as that provided under the Employee Stock Ownership Plan. The Company's cost of this plan for 1997, consisting principally of the accrual for the employer match, was \$493,000.



## 8. PENSION PLANS

### Description of Plans

Substantially all of the Company's employees are covered by two defined benefit pension plans. One of these plans is for non-bargaining unit employees and, through 1996, was non-contributory with respect to annual compensation up to a defined level, with voluntary employee contributions beyond the specified compensation levels. Concurrent with the introduction of the Davey 401KSOP, future benefits earned under this plan were modified, and as of January 1, 1997, the plan was amended to become non-contributory. The other plan is for bargaining unit employees not covered by union pension plans, is non-contributory, and provides benefits at a fixed monthly amount based upon length of service.

### Funding Policy

The Company's funding policy is to make the annual contributions necessary to fund the plans within the range permitted by applicable regulations. The plans' assets are invested by outside asset managers in marketable debt and equity securities.

### Expense Recognition

Pension expense (income) was calculated as follows:

	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
Service cost - increase in benefit obligations earned	\$ 626	\$ 368	\$ 358
Interest cost on projected benefit obligation	849	906	880
Return on plan assets (earnings)	(5,072)	(3,290)	(3,841)
Deferral (amortization) of unrecognized net assets	<u>2,931</u>	<u>1,454</u>	<u>2,303</u>
Net pension income	<u>\$ (666)</u>	<u>\$ (562)</u>	<u>\$ (300)</u>

### Funded Status

The funded status of pension plans at December 31 was as follows:

	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
Plan assets at fair market value	\$ 25,561	\$ 21,488	\$ 19,143
Projected benefit obligation	<u>(12,502)</u>	<u>(12,091)</u>	<u>(12,462)</u>
Excess of assets over projected benefit obligation	13,059	9,397	6,681
Unrecognized initial asset	(1,010)	(1,082)	(1,154)
Unrecognized gain	(7,741)	(4,639)	(3,172)
Unrecognized prior service cost	<u>(663)</u>	<u>(697)</u>	<u>62</u>
Prepaid pension expense recognized as other assets in balance sheets	<u>\$ 3,645</u>	<u>\$ 2,979</u>	<u>\$ 2,417</u>

The projected benefit obligation was determined using an assumed discount rate of 7.00% in 1997 and 7.25% in 1996 and 1995. The assumed long-term compensation rate increase was 5.0%. The assumed long-term rate of return on plan assets was 8.25% in 1997 and 9.0% in 1996 and 1995.

8. **PENSION PLANS (Continued)**

The projected benefit obligation, which includes the effect of annual compensation rate increases, is based on an accumulated benefit obligation of \$11,342,000, \$10,530,000, and \$10,367,000 at December 31, 1997, 1996 and 1995, respectively. It includes vested benefits of \$11,220,000, \$10,390,000, and \$10,115,000, respectively. The January 1, 1997 amendment to the Davey Tree Expert Company Employee Retirement Plan reduced the projected benefit obligation and prior service cost incurred by \$755,000 at December 31, 1996.

**Multiemployer Plans**

The Company also contributes to several multiemployer plans which provide defined benefits to unionized workers who do not participate in the Company sponsored bargaining unit plan. Amounts charged to pension cost and contributed to the plans in 1997, 1996 and 1995 totaled \$380,000, \$395,000, and \$309,000, respectively.

9. **INCOME TAXES**

The approximate tax effect of each type of temporary difference that gave rise to the Company's deferred tax assets (no valuation allowance was considered necessary) and liabilities at December 31, was as follows:

	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
<b>CURRENT</b>			
Assets:			
Compensated absences	\$ 341	\$ 294	\$ 217
Insurance	1,447	1,346	2,419
Other - net	<u>244</u>	<u>146</u>	<u>61</u>
Net current	<u>2,032</u>	<u>1,786</u>	<u>2,697</u>
<b>NON-CURRENT</b>			
Assets:			
Insurance	3,825	3,100	1,986
Liabilities:			
Accelerated depreciation for tax purposes	(4,421)	(4,300)	(4,228)
Pensions	(1,247)	(1,016)	(822)
Other - net	<u>462</u>	<u>264</u>	<u>(118)</u>
Net noncurrent	<u>(1,381)</u>	<u>(1,952)</u>	<u>(3,182)</u>
Net deferred tax asset (liability)	<u>\$ 651</u>	<u>\$ (166)</u>	<u>\$ (485)</u>

Significant components of income tax expense from continuing operations include:

	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
<b>Taxes currently payable:</b>			
U.S. Federal	\$ 6,839	\$ 5,057	\$ 3,721
Canadian	309	144	246
State and local	<u>1,641</u>	<u>1,200</u>	<u>880</u>
	<u>8,789</u>	<u>6,401</u>	<u>4,847</u>
<b>Deferred tax expense (benefit):</b>			
U.S. Federal	(682)	(269)	(704)
Canadian	46	22	18
State and local	<u>(181)</u>	<u>(72)</u>	<u>(187)</u>
	<u>(817)</u>	<u>(319)</u>	<u>(873)</u>
	<u>\$ 7,972</u>	<u>\$ 6,082</u>	<u>\$ 3,974</u>

**9. INCOME TAXES (Continued)**

The differences between the U.S. Federal statutory tax rate and the effective tax rate are as follows:

	1997	1996	1995
U.S. Federal statutory tax rate	34.9%	34.3%	34.0%
State and local income taxes	5.5	5.3	5.6
Canadian income taxes	.7	.5	1.1
Miscellaneous	<u>.3</u>	<u>.9</u>	<u>(1.4)</u>
Effective tax rate	<u>41.4%</u>	<u>41.0%</u>	<u>39.3%</u>

Earnings before income taxes by country are as follows:

	1997	1996	1995
	<i>(Dollars in Thousands)</i>		
U.S.	\$ 18,604	\$ 14,555	\$ 9,669
Canadian	<u>647</u>	<u>286</u>	<u>442</u>
	<u>\$ 19,251</u>	<u>\$ 14,841</u>	<u>\$ 10,111</u>

The Company made cash payments for income taxes of \$7,360,000, \$9,354,000, and \$3,324,000 in 1997, 1996 and 1995, respectively.

**10. CUSTOMER CONCENTRATION**

The Company's major service line, utility line clearance, represented approximately 62% of the outstanding accounts receivable at December 31, 1997, 1996 and 1995. The Company had revenues from one utility customer under multiple year contracts aggregating approximately \$67,000,000 in 1997, \$55,000,000 in 1996, and \$37,000,000 in 1995. The Company had revenues from a second utility customer under multiple year contracts of approximately \$22,000,000 in 1997, \$19,000,000 in 1996, and \$21,000,000 in 1995. The Company performs ongoing credit evaluations of its customers' financial conditions and generally requires no collateral.

**11. OPERATING LEASES**

The Company primarily leases facilities which are used for district office and warehouse operations. These leases extend for varying periods of time up to four years and, in some cases, contain renewal options. Total rental expense under such operating leases amounted to approximately \$1,723,000, \$1,693,000, and \$1,539,000 for 1997, 1996 and 1995, respectively. As of December 31, 1997, future minimum rental payments, including taxes and other operating costs, for all operating leases having noncancelable lease terms in excess of one year, totaled \$3,275,000, and are expendable as follows: 1998, \$1,280,000; 1999, \$867,000; 2000, \$586,000, 2001, \$361,000 and 2002, \$181,000.

**12. COMMITMENTS AND CONTINGENCIES**

The Company is party to a number of lawsuits, threatened lawsuits and other claims arising out of the normal course of business. Management is of the opinion that liabilities which may result are adequately covered by insurance, or to the extent not covered by insurance or accrued, would not be material in relation to the financial position, results of operations or liquidity of the Company.

At December 31, 1997, the Company was contingently liable to its principal banks in the amount of \$7,515,000 for outstanding letters of credit for insurance coverage and guarantees of debt for one of its subsidiaries.

**13. DISCONTINUED OPERATION**

On March 31, 1995 the Company sold substantially all of the operating assets, excluding real estate, of its interior plant care business; in December 1996 it sold the real estate related to this business at an amount approximating its carrying value.

Amounts related to the discontinued operation and recognized in the financial statements are as follows:

	<b>1995</b> <i>(Dollars in Thousands)</i>
Revenues	<u>\$ 553</u>
Loss from discontinued operation, net of applicable income tax benefits of \$116,000	(168)
Gain on sale of assets, less applicable income taxes of \$280,000	<u>404</u>
Discontinued operation, net	<u>\$ 236</u>

**14. ACQUISITIONS**

In 1997, 1996, and 1995, the Company completed acquisitions of organizations providing horticultural services for a total purchase price of \$449,000, \$820,000 and \$2,150,000, respectively. They were accounted for as purchases and their results of operations, which were not material in any of the years presented, are included in the accompanying financial statements from their respective dates of acquisition. Goodwill and other intangibles recognized in connection with these purchases are being amortized over 3 to 15 years.

\*\*\*\*\*