

Mind Your Own Business

Hopefully, you are now more aware of how financial statements fit together. When you make changes on one statement, the change is reflected on another, and when you put them altogether in a *Financial Scoreboard*, you discover the cause and effect. By now, you should be able to see why your financials are important in helping you run your horse business better. *'If you want to deflate a balloon, use a dart. If you want to deflate an opinion, use a number'*. Your business financials are your partner – use them. They are free, they don't get sick unless you make them sick and they only talk back when they should!

What we have discussed so far is the basic financial analysis of a horse business – now it is time to turn it up a notch and do some power analysis. Power analysis shows you how the ratios we have previously discussed fit together. Power analysis allows you to use the connection between ratios to analyze your horse business financials even deeper. The connection between ratios is captured in one equation. This equation includes several of the key ratios that you, as the business owner, should pay attention to and use to make sure you are managing your horse business the best you can. This equation is known as the *Du Pont Equation*. There is the 'Simple' *Du Pont Equation* and the 'Extended' *Du Pont Equation*. We are going to start with the 'Simple'.

To begin understanding the 'Simple' *Du Pont Equation*, we need to start with *Return on Assets* (ROA). We discussed ROA in the previous article. You may want to review that article and the *Balance Sheet* article before continuing. We are going to examine ROA's two parts. The first part is *Return on Sales* (ROS).

$$\text{Return on Sales (ROS)} = \frac{\text{Net Profit}}{\text{Sales}}$$

This might be a good time to look at your business's numbers. Is your ROS positive and growing? Unfortunately, there isn't data available to tell you what a good ROS is for a horse business. Different types of horse businesses have different sales cycles so you need to average sales over different periods of time. The sales cycle of a horse boarding stable is similar to a retail business with not a lot of variation in sales, while a horse breeding business is similar to boat dealer. Sales are seasonal and dependent on seasonal and geographic influences.

Whatever your sales cycle, you can always see if your ROS is improving against your business's past performance. When comparing your ROS there are a few questions you can ask yourself:

1. Are your sales increasing? Are they increasing at an acceptable rate?
2. Are your sales increasing faster than inflation?
3. Are you sales flat or declining?
4. Are you spending money to grow, but your sales are not increasing?

If your sales are increasing, but ROS is not good you may have a profit problem. It may be that your gross margin is decreasing or your expenses are increasing faster than your sales. You can analyze this problem using the ratios you learned in our last article.

We need to do a little math to use the second part of ROA. Math is my friend. I used math courses at the university to recover my GPA after having to take a liberal arts course. But, before we do the math we need to introduce a new ratio. The new ratio is *Asset Turnover*. *Asset Turnover* is:

$$\text{Asset Turnover} = \frac{\text{Sales}}{\text{Average Assets}}$$

Asset Turnover measures how many times in a given period your assets turnover in the form of sales. *Asset Turnover* is also referred to as '*marketing leverage*' because it indicates how much '*Marketing Bang*' you are getting for your '*Asset Buck*'. This ratio measure how your customers are reacting to the resources you have invested on their behalf. If a modest amount of investment generates a lot of sales you invested wisely. Whatever you did, keep doing it! If a lot of investment generates a modest amount of sales you invested poorly. Whatever you did, stop doing it, or at least think about it before continuing to invest!

If everything remains equal, a higher *Asset Turnover* results in a higher ROA. *Asset Turnover* can be increased in two ways: by increasing sales while holding assets steady or by decreasing assets while holding sales steady. Remember our discussion on *Receivables* and *Inventory* in our first article about creating a horse business *Chart of Accounts*, and the analogy of assets to water, ketchup and molasses? Reducing *Receivables* (slow - ketchup) and *Inventory* (very slow and difficult - molasses) not only improves *Cash Flow* as we previously discussed, but also improves *Asset Turnover*. Now that we have introduced *Asset Turnover* and understand how it works we can do our math to complete ROA and our '*Simple*' *Du Pont Equation*.

We know that:

$$\text{Return on Sales (ROS)} = \frac{\text{Net Profit}}{\text{Sales}}$$

We also know from our last article that:

$$\text{Return on Assets (ROA)} = \frac{\text{Net Profit}}{\text{Average Assets}}$$

This allows us to write a new equation that defines ROA as:

$$\text{ROA} = \frac{\text{Net Profit}}{\text{Average Assets}} = \frac{\text{Sales}}{\text{Average Assets}} \times \frac{\text{Net Profit}}{\text{Sales}}$$

Or

$$\text{ROA} = \frac{\text{Net Profit}}{\text{Average Assets}} = \frac{\text{Sales}}{\text{Average Assets}} \times \text{ROS}$$

Or

$$\text{ROA} = \text{ROS} \times \text{Asset Turnover}$$

ROS measures the profit you get from *Sale*, while *Asset Turnover* measures the *Sales* you can generate from your *Assets*. Together they give you a more in-depth understanding of your *Return On Assets* (ROA).

Managers of a horse business generally measure the business's success differently than the owner of the business unless they are one in the same, which is often the case. Manager's generally care more about *Return On Assets* ROA while the business owner cares more about *Return On Equity* (ROE). Managers care more about ROA because ROA tells them how good a job they are doing at managing *Sales*, *Expenses* and *Assets*. The business owner, and shareholders if the business has any, cares more about how much *Profit* they are making for each dollar of *Equity* they have invested in their business. If the manager and owner are one in the same, they care about both ROA and ROE.

Before proceeding, you need to remember the difference between *Assets* and *Equity*. *Assets* are the valuable resources a horse business has and uses in the business. If you remember from the *Balance Sheet* article, the *Total Asset* line on a Balance Sheet includes *Cash* in the

bank; *Receivables* which is the money owed the business; the net book value of a business's *Fixed Assets* such as horses and vehicles; *Inventory*; and other items. However, someone might have a claim against on some of the *Assets*. The claims might be held by vendors, banks and other lenders, and the government. If there are claims, those claims are summed up in the *Total Liabilities* line on the *Balance Sheet*. The remaining claims are held by the business's owners. The business's owners own what is left over. What is left over is their *Equity*. *Total Assets* minus *Total Liabilities* equals *Equity*. I hope you remember this as the basic accounting equation:

$$\mathbf{Assets = Liabilities + Equity}$$

Forgetting all the financial jargon, this is a commonsense concept that people use every day. If you purchase a horse for \$15,000 and you pay \$5,000 down and have a loan on the balance, you know you have \$5,000 worth of *Equity* in that horse. Another example is, if you start a horse business and put \$50,000 of your own money into it and you borrow \$10,000 to purchase a tractor, you have \$60,000 of *Cash* and *Fixed Assets* (tractor). However, since you borrowed \$10,000 to purchase the tractor and there is a loan against it, you still only have \$50,000 in *Equity*. If you are one of the lucky ones and have no accounts payable, no debt, no liabilities of any kind, your *Assets* are exactly equal to your *Equity*. We call the difference between *Assets* and *Equity*, OPM – *Other People's Money*. If your horse business has *Liabilities*, and most horse businesses do, you are using OPM to help generate profit and your *Assets* will be greater than your *Equity*.

The important question from a financial standpoint isn't whether a business is using OPM, but how much OPM is it using and is it using it prudently and productively. A business never wants to borrow more money than it can put to work, and a business doesn't want to borrow more money than it can pay back. Remember the *Debt-To-Equity* ratio we also discussed in the *Balance Sheet* article? This is a useful measurement to show when a business is overextended. The *Debt-To-Equity* ratio is part of another useful ratio, *Asset-To-Equity*. The *Asset-To-Equity* ratio is:

$$\mathbf{Asset-To-Equity = \frac{Average\ Assets}{Equity}}$$

If the *Asset-To-Equity* ratio is 1:1 it means a business has no *Liabilities*. If the ratio is 3:1 it means the business has three times more *Assets* than *Equity*. The *Assets-To-Equity* ratio is also known as '*financial leverage*' or '*equity multiplier*'. It shows how much you are leveraging

OPM. It is the responsibility of the business owner, or whoever is accountable to the owner, to manage this ratio so that the business remains financially sound. If the business is delivering a healthy ROA, and its owner or managers are utilizing the proper amount of *financial leverage*, the business will deliver an even healthier ROE. The reason – they are using OPM. How much is too much *financial leverage*? The rule of thumb is that most established businesses never go much above a 3:1, *Assets-To-Equity* ratio.

You can use ROE to assess any business's performance against any other business, regardless of market segment or industry. In that sense it is the ultimate financial measuring stick. The average ROE for any group of businesses fluctuates between 10 and 20 percent – in good economic times 20 percent, in bad economic times 10 percent.

Now it is time to look at the 'Extended' *Du Pont Equation*. The equation looks like this:

$$\frac{\text{Net Profit}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Average Assets}} = \frac{\text{Net Profit}}{\text{Average Assets}} \times \frac{\text{Average Assets}}{\text{Equity}} = \frac{\text{Net Profit}}{\text{Equity}}$$

or

$$\text{ROS} \times \text{Asset Turnover} = \text{ROA} \times \text{Financial leverage} = \text{ROE}$$

This equation is handy because it breaks down the ultimate financial goal of a business owner – a healthy ROE. It breaks ROE down into all the component parts and helps you understand how to manage each one.

Let's review the equation's component parts and the strategies associated with component.

1. ROS – *Return On Sales*: You manage ROS by managing *Sales* and *Expense*. The key ratio to watch is *Expense/Sales*. No business can afford to have *Expenses* rising faster than *Sales*.
2. *Asset Turnover*: You manage *Asset Turnover* by increasing *Sales* faster than *Assets*, by decreasing *Assets*, or both. The key *Asset* to watch is *Receivables* and *Inventory* since they are the most likely candidates to vary in the short term. The solution is to get paid on time and don't let *Inventory* in the door unless you absolutely need it and then, use it quickly. equineGenie is excellent at managing *Inventory* and conserving *Cash*.
3. ROA – *Return On Assets*: *Return On Assets* improves when *Sales* rise faster than *Expenses* and/or *Assets*. We have discussed managing *Sales*, *Expenses* and *Assets* such as *Receivables* and *Inventory* in previous articles.

4. *Financial Leverage*: The *Assets/Equity* ratio is a great tool to show you if you are taking the appropriate advantage of OPM – *Other People’s Money*. If it is close to 1:1, you may be running your business too cautiously. You may want to take on more debt. If it is higher than 3:1, you may want to back off before you get in financial trouble. More isn’t always better when it comes to *financial leverage*.
5. *ROE – Return On Equity*: For many investors, ROE is the ultimate financial measuring stick. It shows investors if they are better off investing in one opportunity or another. Your ROE must be competitive with other opportunities, or you will may have a difficult time attracting money when you need it. This includes a bank loan. Banks have opportunities to lend money just like investors. They also only have a finite amount to lend. You will be competing for their funds. The best ROE will win!

In the next article we will discuss forward looking financials. We will discuss setting goals, creating plans and making them happen.

To be successful in a horse business does not require a finance education, but it does require an understanding of what your financials are telling you. This understanding will enable you to make better business decisions. A good *Horse Business Management System* will do the calculations for you and analyze and report the results with comments or suggestions. A good *Horse Business Management System* will save you valuable time you can then use to improve your business. I encourage you to investigate how *equineGenie* not only helps you manage and care for your horses and manage your business operations and support your customers, but helps you be financially successful.

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