Mind Your Own Business

You may be asking by now, what is the point of all this financial analysis that has been presented in the previous seven articles? It isn't to make work for your accountant – although it might if you have an accountant. It isn't to have something to impress your banker – although it may help if you need a loan. It is to help you manage your horse business more effectively and to help you reach your financial goals.

Before you start putting all this knowledge to use, the important thing is that you know what your goals are. Financial analysis can show you how you are doing on your way to your goals, but only you can determine the destination you want to reach in your horse business. If you don't have goals and a destination, you won't know what the numbers are telling you. *If you can't measure it, you can't manage it - and you can't measure it if you don't have goals, milestones and a plan.*

Whether you have a strong balance sheet with little debt compared to equity and a healthy net profit, or a weak balance sheet and little or no profit, and maybe even a loss, which isn't necessarily bad if you have clear goals and a plan for achieving them. Maybe your weak balance sheet and lack of net profit is because you are in the early stages of your horse business. Obviously, you will eventually need to make a *Net Profit*, achieve positive *Operating Cash Flow* (OCF), and record a healthy *Return on Assets* (ROA). Your plan to reach your destination should include a timeline to reach each of your milestones and achieve your goals.

It is also helpful to remember that everything that is important in your horse business isn't always captured in your financials. To be successful in running a horse business you need to do a lot of things right. It doesn't matter if you are a horse breeder, horse trainer, board horses or give riding lessons, etc.; you need to offer a product or service at a price customers are willing to pay. You also need to have effective sales and marketing campaigns, and if needed hire good people and provide good leadership. You need to plan for the long term as well as the short term and figure out an appropriate balance between them. It is important to remember that your financials can tell you how you are doing at managing the parts of your horse business measured in dollars, and that is a lot, but not everything. Your financials won't tell you how loyal your customers will be tomorrow, or if your competitor comes out with a better product or service, or if you have hired the best people.

The 'bottom line' is that your financials are extremely important if you want to run a successful horse business. They provide you with the kind of insight into the performance of your business

that only a good set of financials can provide. But, you must know where you want to go and you must pay equal attention to the nonfinancial aspects of your business.

If you are the owner, your job is relatively simple. Your job is to manage sales, expenses and assets in such a way that your business reaches its financial goals. Nonfinancial goals may differ from one horse business to another, but there are three financial goals that are essentially the same for all types of horse businesses:

1. Most businesses must make a profit in the short term, but all businesses must make a profit in the long term. They must make enough profit to invest in the future or pay dividends to stakeholders (you are a stakeholder), or both.

2. A business must generate enough cash to pay its bills. This is an immediate requirement. Remember, "*You can operate a long time without profit, but you can't survive one day without cash*." A business must monitor the rate at which they are consuming cash. If they are a new business they need a plan that shows how and when they will change from a cash consumer to a cash generator.

3. A business must provide a sufficient return on investment to be competitive with alternative sources of funds. If a business doesn't provide a sufficient return on investment they will have a difficult time procuring funds when they need them.

Hopefully, you have read the previous articles and remember enough to realize that these three generic goals correspond exactly to the three bottom lines we previously discussed: *Net Profit*, *Operating Cash Flow* (OCF), and *Return on Assets* (ROA).

Now it is time to see what you as an owner or manager must do to maintain the three healthy bottom lines in your horse business. The first bottom line we are going to discuss is managing *Net Profit* for optimum performance. *Net Profit* is reported on the *Income Statement*. You can review the *Income Statement* in the *August 2012 issue of the Desert Mirage Magazine* or on the *equineGenie website* in *The 'Genie Academy* section.

Too many business owners and managers get their financials at the end of a month or at the end of a quarter and just glance at them. Using your financials in this way is hardly using them at all. If you are an owner or manager of a horse business, you want to know not only what happened, but why it happened and in a timely manner. You also want to know what you can do about it as soon as possible. This timing requirement is my 'beef' with accounting only software like QuickBooks and horse management software that only keeps horse records and minimal financial information. Accounting and record keeping are history and in most cases the

information they provide is not timely and often too late. The *equineGenie* software system not only incorporates accounting, it also incorporate financial management and analysis so when you make an entry, *equineGenie* immediately analyzes and reports how that entry affects your business so that you can make any necessary changes in a timely manner.

Net Profit is what most businesspeople are taught to manage and that is probably what your accountant, if you have one, tells you to focus on. The chances are you are probably already looking at the number that appears on the bottom line of your *Income Statement*. But, what do you do if you have a low profit problem or worst yet, no profit or a loss? You know from understanding an *Income Statement* that it consists of *Sales* and *Expenses*, so the first thing you should check is to see if your *Sales* are on target. If they are not, you need to analyze your *Sales* number in more detail. We will discuss how to analyze your *Sales* number in detail when we discuss *Return on Assets* later in this article. Next you want to look at *Expenses*. You don't want to look at the absolute level of *Expense*, but *Expense* compared to *Sales*. The key ratio that determines *Net Profit* is to divide *Expense(s)* by *Sales*.

$$\frac{\textit{Expenses}}{\textit{Sales}} \textit{ X 100} = \textit{\% Expense of Sales}$$

There are a couple of ways to determine if your ratios are giving you a positive or negative message. The first is to compare your performance with the performance of similar horse businesses. Financial people who have worked with horse businesses for a while generally know what is considered a reasonable level of *Expense* for a given level of *Sales*. If you can't find what the reasonable levels should be for your horse business, give me a call or email me and I will give you the levels I use.

The second method when comparing results is to calculate each *Expense* line item as a percentage of sales. This enables you to tell at a glance which *Expense* line items to focus on. This is particularly an advantage when you are comparing one financial period to another. If a ratio percentage is trending upward you should be concerned that there might be a problem. An upward trend tells you that you need to investigate deeper into the offending line item. For example; maybe your advertising expense is increasing with no increase in *Sales*. Maybe your office overhead has increased without adding any staff. Maybe your feed costs have increased without adding any horses.

The key here is to do your analysis intelligently. First, figure out which numbers have the biggest impact on your financials. Next, figure out which numbers are most likely to have changed.

Concentrate on the numbers that might be the source of your problem. You also need to compare where you are with where you want to be. It isn't a sin to have negative profit it you know why and have a well thought out plan to become profitable. Finally, remember that the numbers are just numbers and the real story lies behind them. As you analyze your financials you will learn about problems that were solved and challenges that remain.

The *equineGenie horse business management system* automatically represents *Sales* and *Expense* in absolute levels and percentages for easy comparisons and compares results between different financial periods flagging any suspicious items.

Hopefully, you are starting to learn one key lesson: the *Financial Statements* provide the *Big Picture*. They show you where your horse business has its strengths and weaknesses. They also provide the entry point for you to drill down to pinpoint exactly what is behind those strengths and weaknesses. You can move from the *Big Picture* to the specific and back again, and in doing so you can figure out what needs to be done to improve your business.

The next 'bottom line' we are going to discuss is managing *Operating Cash Flow* (OCF) for optimum performance. *Operating Cash Flow* (OCF) is reported on the *Cash Flow Statement*. You can review the *Cash Flow Statement* in the *October 2012 issue of the Desert Mirage Magazine* or on the *equineGenie website* in *The 'Genie Academy* section.

Very few businesspeople are taught to manage *Cash Flow* and yet, *Cash Flow* is every bit as important as *Net Profit*, and more important in the early phase of a horse business. For a small of growing horse business, *Cash Flow* is the life blood of the business. If a small horse business runs out of *Cash* it usually goes away. For large healthy horse businesses, *Cash Flow* is the best way to test its quality of earnings. It tells you if the abstract profits recorded on the *Income Statement* are being converted into real money. Remember: *Profit* is an accounting opinion, *Cash* is fact.

Once a horse business is past the start-up phase the key test of its *Cash Flow* health is its *Operating Cash Flow* (OCF). You want to compare it with other numbers to make sure it is moving in the right direction. When financial analysts look at a business, one of the first things they are likely to do is look at the OCF numbers and apply four tests:

1. Is *Operating Cash Flow* (OCF) positive? A business must have positive OCF. If your *Operating Cash Flow* (OCF) isn't positive, you need to find out why very quickly.
2. Is *Operating Cash Flow* (OCF) greater than *Net Profit*? In almost all cases it should be. *Net profit* is reduced by allowances for depreciation and other noncash non-operating

items. If your *Operating Cash Flow* (OCF) is smaller than *Net profit* you need to find out why you are not successfully turning your *Net profit* into *Cash*.

3. Is *Operating Cash Flow* (OCF) greater than *Fixed Asset* investment? If it is, it means you are funding your investment internally which is better than relying on outside investment.
4. Is *Operating Cash Flow* (OCF) trending in the same direction as *Net Profit*? If your *Net Profit* is heading up while your *Operating Cash Flow* (OCF) is heading down you have a problem.

Remember from our previous articles on the *Income Statement* and *Cash Flow Statement*. *Net Profit* is an abstraction. The whole *Income Statement* is an abstraction. You can't spend an abstraction. You can only spend *Cash. Net Profit* only shows one part of a business transaction, the contractual part. If you sell a horse to a customer, it counts as a *Sale* on the *Income Statement* whether or not you have actually been paid. The costs associated with providing the horse to your customer counts as an *Expense* on your *Income Statement* whether or not you have actually written the checks to cover them.

What happens if you make a lot of *Sales*, but don't collect the money? You might be showing a healthy profit, but poor *Cash Flow*. Too much of your profit is tied up in *Receivables*. What happens if you purchase feed in hopes of getting more boarders? You pay for the feed, but you haven't got the new boarders yet. Too much of your profit is tied up in *Inventory*. There may be other reasons for poor *Operating Cash Flow* (OCF) compared to *Net Profit*. You may be paying your bills faster than you need to and faster than you can collect your *Receivables*. In most cases the two biggest variables are *Receivables* and *Inventory*. Weak *Operating Cash Flow* (OCF) compared to Net profit usually means that you or the people managing your horse business are doing a poor job managing receivables or Inventory, or both.

Fortunately, there are some great tools available to find out where the problem lies. There are several *Receivables* and *Inventory* ratios that will help you find problems. In our next article on Ratios Magic we will investigate these ratios and several others that will help you manage your horse business and your *Operating Cash Flow* (OCF). In the meantime, remember *Inventory is Cash at rest*. Never buy in bulk just to take advantage of a good price while forgetting the cost of carrying the *Inventory* and the *Cash* you are tying up. The savings you might enjoy from a bulk purchase may make you run out of *Cash*. We will explore *Inventory* in more depth in a future article.

In summing it all up, poor *Operating Cash Flow* (OCF) can stem from many problems, but in most cases it's the result of poor *Receivables*, *Inventory* and *Payables* management. If your horse business is just starting up or if it is growing rapidly, your *Operating Cash Flow* may look terrible. However, if it is where you want it, and you have a plan for turning it around, and you have a reliable source of *Cash* to keep you in business, you don't have to worry about it. The time to worry is if your horse business is apparently healthy and profitable, but you are not turning your profits into *Cash* and you are not sure why.

The *equineGenie horse business management system* knows that '*Cash is King*' in a horse business and watches it with a hawk's eye.

The last and third 'bottom line' we are going to discuss is managing *Return on Assets* (ROA) for optimum performance. You can review *Return on Assets* in the *December 2012 issue of the Desert Mirage Magazine* or on the *equineGenie website* in *The 'Genie Academy* section.

Return on Assets (ROA) is the 'bottom line' that is not denominated in dollars. Dollars are great. *Net Profit* dollars shows if you are making money on your overall *Sales*. The *Operating Cash Flow* dollars tells you whether you are converting your profits into *Cash*. However, if you only look at dollars you don't have the full picture of how your horse business is doing. You don't have all the measures you need. As your horse business grows you expect your *Net Profit* and *Operating Cash Flow* to increase, but by how much? Are they keeping up with the growth? Are they increasing as fast as they should? Does your horse business have other objectives besides profitability, such as protecting and perhaps increasing its market share? How much profit can you afford to give up in pursuit of these objectives? To answer these questions you need ratios and to be more precise, you need the third 'bottom line' ration, which is *Net Profit* divided by average *Assets*.

$$\textit{Average Assets} = \frac{\textit{Beginning Assets} + \textit{Ending Assets}}{2}$$

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

Return on Assets (ROA) is important for two reasons. First, it helps with the internal financial management of your horse business. Anyone running a horse business has to make sure the business has adequate *Sales* and that the *Sales* are growing. Anyone running a horse business

has to watch the business's *Expenses* to make sure they don't exceed *Revenue*. Last, but not least, anyone running a business has to manage the business's resources which are called *Assets*. Assets include *Current Assets* such as cash, accounts receivables, inventory, and *Fixed Assets* such as buildings, vehicles and horses used to make money. You want to make sure your *Assets* are working for you as much as possible. If you are running a ridding lesson business, you want to make sure your lesson horses are not sitting idle, not generating any revenue and getting fat eating your expensive hay.

The second reason *Return on Assets* (ROA) is important is that it helps anchors a business's performance in the outside world. You always need to know how your business is doing against your competition. Are you pushing hard enough? Are you doing as good a job as your competition in managing your *Sales*, *Expenses* and *Assets*? Are you as profitable as your competition? Dollar figures alone can't answer these questions, because the same type horse businesses come in vastly different sizes. *Return on Assets* (ROA) lets you see actually how you stack up. You don't have to be big to be good, but you do have to be able to accurately compare your horse business with larger horse businesses of the same type.

Remember from a previous article, *Return on Assets* (ROA) is an abstraction because the numerator in the ratio, *Net Profit*, is an abstraction. For this reason, focusing on *Return on Assets* (ROA) without tracking *Operating Cash Flow* (OCF) is a mistake. Although, *Net Profit* is an abstract number, it is a very good indicator whether your horse business is really making money on the products and or services it delivers. Although, your *Assets* can vary somewhat depending on the financial rules they are setup under, *Assets* are far from abstract. The *Cash*, *Receivables*, *Inventory* and *Fixed Assets* on your *Balance Sheet* are valuable resources. How effectively you use them to generate profit is a good measure of your business's economic performance.

Return on Assets (ROA) shows what you are doing with the money your customers, creditors and investors (if you have any) are transferring to you. As the owner or manager of your horse business, you are spending money for feed, payroll, materials, and Fixed Assets. You are getting your customers to promise to pay for what you give them, so you are generating *Receivables*. You are collecting those *Receivables*, so you are generating *Cash*. *Return on Assets* (ROA) is one of the tools to show how well you are doing at all these tasks.

So what constitutes a healthy *Return on Assets* (ROA)? As with many financial ratios, there is no single benchmark and average *Return on Assets* (ROA) can vary from one type of horse

business to the next. However, there are three good points of comparison to assess your *Return on Assets* (ROA).

1. You can ask financial people or accountants who have been around your type of horse business longer than you have.
2. If your horse business has been operating for a while, you can make a chart of you own *Return on Assets* (ROA) over time (*equineGenie* does this for you). You expect *Return on Assets* (ROA) to increase over time, but if it starts to decline and you don't know why, you know you have a problem and you had better solve it.
3. You should be forecasting your *Return on Assets* (ROA) for the current year. At the end of the year you compare your forecasted *Return on Assets* (ROA) with your actual *Return on Assets* (ROA). If you don't achieve your forecasted *Return on Assets* (ROA), that is another sign you may have a problem.

We will analyze *Return on Assets* (ROA) ratios in more depth when we discuss Ratios Magic in our next article – stay tuned.

One important point about *Return on Assets* (ROA): it provides a useful measuring stick for your horse business to evaluate your investment in *Fixed Assets* – a new barn, a new truck, another horse, a new computer system, etc. Investment in *Fixed Assets* should pay off in the form of higher *Sales* or decreased *Expenses* as a percentage of *Sales*, both resulting in a higher *Net Profit*. You can test whether it does or not by making a graph of *Net Profits* over time and a graph of net *Fixed Assets* over time. Ideally, both should be rising, but if *Net Profit* isn't rising faster than net *Fixed Assets*, your *Fixed Assets* are not paying off financially. The *equineGenie horse business management system* provides these graphs and the analysis for you.

In short, *Return on Assets* (ROA) is the last step in the basic analysis of your business's financial performance. If *Return on Assets* (ROA) is declining, a *Net Profit* analysis or Cash Flow analysis may already have revealed the problem, but if every trend is healthy except *Return on Assets* (ROA), then you have a *Fixed Asset* problem. You can prove it by comparing *Net Profit* with your net *Fixed Assets* as previously described.

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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