Mind Your Own Business

In this article we are going to discuss the *Big Picture* and what the *Bottom Line* on your *Balance Sheet*, *Income Statement* and *Cash Flow Statement* tell you. I am sure you have heard the jargon '*Green Visor*' associated with someone poring over financial information from these three financial documents. '*Green Visor*' people learn a phenomenal amount about a business just by studying its numbers. The numbers in each of the three documents help them spot the strengths, vulnerabilities and challenges of the business they are analyzing. Their analysis often determines whether a business gets investors or a loan or in the extreme, its chances of continued existence.

Wouldn't it be great if you could be the '*Green Visor*' for your own business? Think how valuable it would be if you understood your business's *Big Picture*. You could manage your business intelligently and understand how to optimize its performance and achieve your goals. Without a financial understanding of your business you're flying blind. You really don't know if your business is OK, or if it is declining or improving.

The first step in understanding your *Financial Big Picture* is to review the previous articles on what a *Balance Sheet*, *Income Statement* and *Cash Flow Statement* are and what kinds of information they contain. These previous articles can be found in past issues of your Desert Mirage Magazine or on www.equinegenie.com in *The 'Genie' Academy* section. Reviewing these articles will help you understand what *Equity* is or how *Profit* differs from *Cash*. There is no avoiding the basics if you truly want to graduate from *Checkbook Management* to *Business Management*. Success comes when you understand what these three statements tell you, why you need all three and how they fit together.

Let's begin with the fact that a well-run business has a *Balance Sheet*, *Income Statement* and *Cash Flow Statement* and each one has its own *Bottom Line*. Many business people never associate a *Bottom Line* with anything other than the *Bottom Line* on their *Income Statement*. After all, everyone knows that the financial goal of a business is to make a profit and increase the *Bottom Line*. *Oh Boy - If it was only that simple!* Unfortunately, many business owners only use their *Income Statement* as their financial management document. *Income Statement Management* is not much better than *Checkbook Management*. If you have been in business for a while you know profit alone is never a sufficient measure of a company's performance. If you remember, in the article on *Cash Flow*, a positive bottom line on your *Income Statement*, showing that your horse business is making a profit, is a good thing. However, profitability is no guarantee of success or even survival. Every day thousands of businesses fail. They '*grew broke*.' A very wise person once told me; "*You can operate a long time without profit, but you can't survive one day without cash*." Cash is real money. Information about cash coming in and cash going out of your business isn't abstract, it is fact. In short, the answer is that profit is only one measure of a business's financial performance. I am not saying it is a bad one, but it can't do the job by itself. You can't get an accurate picture of your company's financials without all three financial statements, and you can't begin to evaluate your company's financial performance without the three distinct *Bottom Lines* each statement provides.

Net Profit comes from your *Income Statement* and shows for a given period of time if your sales exceed your expenses. It shows if you are making money. As a financial performance measurement it has a lot going for it.

- *Net Profit* is accepted by the business world and the business world understands it.
- *Net Profit* isn't distorted by unpredictable changes in cash flow.
- *Net Profit* spreads depreciation over an *Asset's* useful life so that your profit doesn't evaporate because you bought an expensive horse or tractor.

It also has many drawbacks as a financial performance measurement.

- *Net Profit* doesn't tell you how much cash is actually going into your bank account.
  - Maybe your receivables are increasing.
  - Maybe you are purchasing too much inventory.
- *Net Profit* is susceptible to accounting distortions. (*Profit is an accounting opinion, Cash is fact*)
  - Accountants can choose various legitimate methods of calculating depreciation and valuing inventory.
- The *Income Statement* is an abstraction, so *Net Profit* is an abstraction.

Operating Cash Flow (OCF) is our next *Bottom Line*. It is a great *Bottom Line*. *OCF* is found on your *Cash Flow Statement*. We have previous discussed *OCF* and how it is calculated in the article on the *Cash Flow Statement*. In review, *OCF* shows how much net cash is flowing into your horse business, independent of what your business receives from lenders and investors and independent of what you spend on *Fixed Assets* and other investments. It shows the *Cash* you're generating from operations.

Unlike *Net Profit*, *OCF* is helpful because it is based on real financial events – *Cash* going in and *Cash* going out, and not on accounting theory.

- *OCF* cannot be manipulated by following different rules in preparing financial statements.
- If your *OCF* is consistently positive you know you are generating enough *Cash* to meet your financial obligations.
- *OCF* can be used to test the quality of your horse business's profit.
- *OCF* should be consistently larger than *Net profit*.
  - It measures if you are doing a good job managing *Assets* such as *Receivables* and *Inventory*.
  - It measures if you are doing a good job turning *Net Profits* into *Cash*.

You might ask why not use *OCF* as a single *Bottom Line*? Good question – but unfortunately, OCF can be manipulated externally.

- You can arrange or decide to pay your vendors late, temporarily increasing your *OCF* (*robbing Peter to pay Paul*).
- You can sell your accounts receivable to a factoring business.
  - A factoring business will pay you a reduced amount for your receivables and then attempt to collect the full amount from your customers (*not a good message to send to your customers*).
  - Factoring can cost as much as 30% and will hurt your immediate profits (*$1.00 in sales becomes $0.70 in revenue*).

Our third *Bottom Line* is *Return on Assets (ROA)*. *ROA* is calculated by taking *Net Profit* from your *Income Statement* and dividing it by your average *Assets* on your *Balance Sheet* over the same time period.

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

$$\textbf{\textit{Average Total Assets}} = \frac{\textbf{\textit{Total Assets}}^{(1)} + \textbf{\textit{Total Assets}}^{(2)}}{2}$$

For example, if *Assets* at the beginning of a time period (1) are $5 million and your *Assets* at the end of the time period (2) are $5.4 million; your average *Assets* for the period are $5.2 million. If you made $300,000 during the same period your *ROA* is 5.77% (*not bad in a <1% savings account interest environment*).

ROA is an excellent *Bottom Line* measurement. It takes into account *Net Profit* so it shows if you are doing a good job managing your *Sales* and *Expenses*. It also shows how effectively you are managing your *Assets* such as *Receivables*, *Inventory* and *Fixed Assets*.

You might now ask why not use *ROA* as a single *Bottom Line*? Another good question – but unfortunately *ROA* has its draw backs.

- *ROA* is a little more complex than the other measurements so it can be harder for people without financial training to understand.
- *ROA* is also an abstraction.
  - *Net Profit* is in the numerator and has the problems described above.
  - Average *Assets* in the denominator depend on how *Inventory* is valued and *Fixed Assets* are depreciated.
- *ROA* doesn't tell you how much *Cash* you netted last month.

Hopefully, you can see now why you need all three *Bottom Lines* to see your *Big Picture*.

- Your horse business can look good in terms of *Net Profit*, but poor when you consider *ROA*.
- Your horse business can be earning a profit, but unable to meet your next payroll because there is not enough *Cash*.
- Your horse business can have a satisfactory *ROA*, but have flat or declining sales – a real recipe for disaster (*no customers, no business*).

Using all three *Bottom Lines* you can tell if you are really making money. You are able to analyze your business just like the '*Green Visor*' without the expense of a '*Green Visor*'. But, like the '*Green Visor*' you can '*read the tea leaves*' and identify your business's strengths and weaknesses. Improvement of the three *Bottom Lines* should be your goal for your horse business.

Every business needs to make a *Profit*, generate *Cash* and produce a good *Return on Investment* to be competitive and remain competitive. All three *Bottom Lines* give you a powerful tool you can use to evaluate your horse business's performance. The best part is that you do not need a degree in finance to understand and use them. All you need is practice and a good Horse Business Management Software – equineGenie.

There is one more thing to keep in mind when you are assessing your horse business. You need to start building trend charts. The reason is simple: your financials for one time period are a good starting point, but they don't tell you much by themselves. What you really want to know is how your business is performing over time and whether the three *Bottom Lines* are improving or declining.

For one year, a complete set of financials includes two Balance Sheets – beginning and ending, an Income Statement and a Cash Flow Statement. To evaluate your business correctly you need at least three years' worth of *Financial Statements* showing all three *Bottom Lines*. This lets you chart Net profit, Operating Cash Flow (OCF) and Return on Assets (ROA) over time. It will identify the real strengths and weaknesses of your horse business. The financial statements equineGenie provides let you see where you are at a glance, your business trends and where you are winning and losing.

This article completes the discussion on the three *Bottom Lines*. Knowing what each *Bottom Line* tells you is fundamental to you beginning to measure and manage your horse business. Next we will look at creating a *Financial Scoreboard* and the effects changes in one *Financial Statement* has on another.

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.

Bob Valentine, Ph.D.
President
GenieCo, Inc.
Box 271924
Ft. Collins, CO 80527
1.888.678.4364 or 970.231.1455
bob@genieatwork.com
www.equinegenie.com

Dr. Valentine taught Equine Business Management to graduating seniors in the Equine Science Department at Colorado State University. He has been involved in the horse business for too long. If you have any questions, you can reach Bob at bob@genieatwork.com, or call him at 1.888.678.4364 or 970.231.1455 (mobile)