Mind Your Own Business

In a difficult equine market with increasing cost, we can all use all the help we can get to survive this bump in the road. Many of us in the market have to create our own economic stimulus by being smarter; more organized and more efficient using tools that will help us gain and sustain a competitive edge. You can make money in an equine business and still love your horses. In fact, the current economic environment provides an excellent opportunity to get your business right sided and emerge a much better business with the potential to gain market share going forward. Even if you don't operate as a business the same principals apply: Using your money wisely may provide the opportunity to attend another horse show or event or do something special with your horse. *Think – plan – organize – execute – make/save money*.

I am sure many of you have heard the expression '*money is made by either earning it or saving it'*. I would add, '***if you can't measure it, you can't manage it'***. I call this '***management before the numbers****'*. There are many good accounting packages on the market, and accounting is important. Accounting provides the 'score cards' that are used to report your business results to your banker, creditors, government agencies, etc. The most common business reports are the *Income Statement* (profit & loss), *Balance Sheet* (statement of your business's net worth) and *Use of Cash* (flow of cash in and out of your business). However, the problem with accounting as a management tool is '*accounting is history*. Waiting until an accounting period is closed can be too late to prevent an immediate financial disaster. This is the same problem with the so-called horse management programs that only record information. Record systems are history and not management. History in a business is important, but you really need tools that will help you *manage your business day-to-day* and *create* history. The ideal environment is to have a management tool that integrates your horse care, business operations, accounting, financial analysis and report generation while providing real time information '*so nothing falls through the cracks'*.

When setting up a horse business's management system an important initial step is to match your *Chart of Accounts* with the items you want to measure so they can be managed successfully. The items you select should help you optimize your work flow, have a positive influence on your profitability, maximize customer satisfaction and last but not least, *conserve cash*. Cash in an equine business is *KING*. The quality time you spend setting up your *Chart of*

Accounts will pay dividends as you move forward in operating and managing your business. If you have or had an accountant help you setup your business, make sure you have a significant input in what accounts are in your business's *Chart of Accounts*. No one knows your business better than you do.

When setting up your *Chart of Accounts* don't just limit your thinking to expenses. One of the most important management areas in a business is *Asset Management*. Asset Accounts fall into two major categories; *Current Assets* and *Fixed Assets*. *Current Assets* are assets such as petty cash, your checking account, accounts receivable (money owed to you) and inventory. Inventory is supplies on hand to run your business, horses your business has produced to sell, etc. Accounts receivable and inventory can be big cash consumers. If you aren't collecting from people who owe you money, than they are consuming your cash. If you aren't paying attention to your inventory you can have too many supplies and you will be consuming cash on items you do not need. Too much inventory also creates a financial risk if supplies are in inventory too long and they spoil or get lost. *Fixed Assets* are generally *BIG* capital expense items and therefore, consume a lot of cash. Items that fall into the *Fixed Asset* category are horses purchased for your business for lessons, trail rides, etc, vehicles, equipment like tractors and ATV's, Buildings, etc. You need to make sure all your *Fixed Assets* are producing, and furthermore producing at a level where they are providing you with a *Return on Investment* (ROI). Before a fixed asset is purchased you should determine the ROI that is acceptable to you. An acceptable ROI is generally equal to or better than the ROI you can get using your money in another investment. There is also an element of risk that needs to be considered in any investment – the higher the risk the higher the ROI required. If the asset is not meeting your expectations, then you need to solve the problem or sell it. You will not be able to make that determination without setting up your system to measure the assets productivity.

We need to discuss *Current Assets* in a little more depth. *Current Assets* play a major role in two important financial measurements: the *Current Ratio* and the *Quick Ratio*. The *Current Ratio* is one of the best known measures of a business's financial strength and is important to any potential creditor. The *Quick Ratio* is sometimes called the 'acid-test' ratio, because it is one of the best known measures of a business's *liquidity*. *Liquidity* is a business's available cash. In both ratios *Current Assets* are in the Numerator. The Numerator is the part of a ratio (common fraction) appearing above the line and representing the parts of the whole that are

being considered. The difference between *Current* and *Quick Ratios* is the *Current Assets* that are included in the respective Numerators. *Current Assets* are assets on the *Balance Sheet* that represent cash and assets that are expected to be converted into all cash within the next 12 months. Previously, we identified *Current Asset* as Cash Accounts, Investment Accounts, Accounts Receivable and Inventory. I classify these accounts in three categories by a measure of their liquidity; Cash is Water, Investments and Receivables are Ketchup, and Inventory is Molasses. Because the *Current Ratio* is a measure of a business's *financial strength*, all *Current Assets* are included in the Numerator. However, since the *Quick Ratio* is a measure of a business's *liquidity*, only liquid assets like Cash, Investments and Receivables are included in the Numerator. The reason inventory is not included is it is difficult to turn inventory into cash in a short period of time, i.e., slow moving molasses. Sometimes even *Receivables* are questionable if you have too many slow paying customers. Before we can do any analysis or reach any conclusions related to the *Current Ratio* and the *Quick Ratio* we need to discuss *Current Liabilities* and what they represent.

Current Liabilities are what a business currently owes to its vendors and creditors. *Current Liabilities* are short-term debts, all due in less than a year. Paying them off normally requires the business to convert some of its *Current Assets* into cash. Beyond simply being bills to pay, liabilities, as confusing as this might sound, are also a source of assets. Any money that a company pulls from a line of credit, or postpones paying from its *Accounts Payable*, is an asset that can be used to grow the business. For example, delaying your payables to your vendors from 30 days to 60 days can increase your Cash by the amount owed over the next 30 days. This is only viable if your use that cash to improve your business and can get your payables back on schedule in a reasonable amount of time. As the expression goes; '*don't rob Peter to pay Paul*'.

There are five main categories of *Current Liabilities*.

- *Accounts payable*: This is the money the business currently owes to its vendors, creditors, partners, and employees - the basic costs of doing business that the business hasn't yet paid.
- *Accrued expenses*: Unpaid payroll expenses, unpaid interest on notes, and taxes incurred but not yet paid

- *Income tax payable*: This is a specific type of accrued expense -- the income tax a business accrues over the year, but does not have to pay yet, according to various federal, state and local tax schedules.
- *Short-term notes payable*: Notes a business has that need to be repaid within the next 12 months.
- *Portion of long-term debt*: The portion of a business's longer-term obligations that need to be repaid within the next 12 months.

Setting up a measurable and manageable *Chart of Accounts* in the *Accounts Payable* category can have a significant operating and financial impact on a business. Although *Accounts Payable* is a major category under *Current Liabilities*, a business should use a management system that allows it to define multiple vendor subaccounts for the same products and services. Defining a separate subaccount for each vendor lets a business measure that vendor's impact on their business's use of cash, the vendor's product and service quality and the vendor's delivery performance. A late load of hay is trumped by a late load of bad hay. The right system that is setup correctly will only allow this to happen once. However, the proper vendor selection will prevent it from ever happening. Remember, the items you select should help you optimize your work flow, have a positive influence on your profitability, maximize customer satisfaction and last but not least, conserve cash. Measuring your vendors and what they supply is a major component in this objective – *price, terms, quality and delivery*.

Another category under *Current Liabilities* that deserves attention is *Short Term Notes Payable*. This is particularly true if a business has multiple short term notes – and many do. The *Chart of Accounts* in this area should allow management of each note. A subaccount associated with each note will enable the business to minimize a note's impact on the business's profitability and cash. The business will be able to make the correct management decisions on each note and all the notes in total – which ones to pay off, which ones to renegotiate, which ones to discount and sell.

Now that we have a better idea of what makes up a business's *Current Liabilities*, we can use our *Current* and *Quick Ratios* to make our first financial analysis in our business. In both ratios the Total *Current Liabilities* are in the Denominator. The Denominator is the number below the line in a ratio (simple fraction), which indicates the number of parts making up the whole.

The *Current Ratio* formula is:

$$\textbf{\textit{Current Ratio}} = \frac{\textbf{\textit{Total Current Assets}}}{\textbf{\textit{Total Current Liabilities}}}$$

The main question the *Current Ratio* addresses is: Does your business have enough *Current Assets* to meet the payment schedule of its current debts with a margin of safety for possible losses in *Current Assets*, such as inventory shrinkage or uncollectable accounts? A generally acceptable *Current Ratio* is 2:1. But whether or not a specific ratio is satisfactory depends on the nature of the business and the characteristics of its *Current Assets* and *Current Liabilities*. The minimum acceptable *Current Ratio* is obviously 1:1, but that relationship is usually playing it too close for comfort.

If you feel your business's current ratio is too low, you may be able to improve it by:

- Paying off some debts. (Yes)
- Increasing your *Current Assets* from loans or other borrowings with a maturity of more than one year. (Hum – most likely delaying the problem)
- Converting non-current assets into *Current Assets*. (Asset Management)
- Increasing your *Current Assets* from new equity contributions. (Yes – Grow the business)
- Putting profits back into the business. (Yes – It all starts with selling something)

The *Quick Ratio* is computed as shown:

$$\textbf{\textit{Quick Ratio}} = \frac{\textbf{\textit{(Cash + Investments + Receivables)}}}{\textbf{\textit{Total Current Liabilities}}}$$

The *Quick Ratio* is a much more exacting measure than the *Current Ratio*. By excluding inventories, it concentrates on the really liquid assets, with value that is fairly certain. It helps answer the question: If all sales revenues should disappear, could my business meet its current obligations with the readily convertible '*Quick*' funds on hand? An acid-test of 1:1 is considered

satisfactory unless the majority of your *Quick Assets* are in accounts receivable, and the pattern of accounts receivable collection lags behind the schedule for paying your *Current Liabilities*.

The last liquidity ratio I want to discuss is the *Cash Ratio*. If you remember I said, 'Cash in an equine business is *KING*'. Therefore, I call the *Cash Ratio* the *Horsemen's Ratio*.

The *Cash Ratio* formula is:

$$\textbf{Cash Ratio} = \frac{\textbf{(Cash + Cash Equivalents)}}{\textbf{Total Current Liabilities}}$$

The *Cash Ratio* is the most conservative *Liquidity Ratio* because it excludes all *Current Assets* except the most liquid: Cash and Cash equivalents (Marketable Securities). The *Cash Ratio* is an indication of a business's ability to pay off its *Current Liabilities* if for some reason immediate payment were demanded. Receivables and Inventory are eliminated from the Cash Ratio. If you remember, receivables are like ketchup and can be slow to collect and inventory is like molasses and difficult to turn into cash. A *Cash Ratio* of 1:1 is good. It means you can feed and care for your horses in difficult times. It also means you have the opportunity to gain an advantage and be a much better business with the potential to gain market share from your not so financially astute competitors.

I suggest you do a *Current Ratio*, *Quick Ratio* and *Cash Ratio* on your business even if you don't operate as a business. Remember, spending your money wisely may provide the opportunity to attend another horse show or event or do something special with your horse. A good management system will calculate and analyze these ratios for you.

In your *Chart of Accounts* you may have to manage or at least monitor what is called *Other Assets*. *Other Assets* include all *Balance Sheet Asset Accounts* not covered specifically in other areas of *Asset Management*. Often, such accounts may be quite insignificant to the overall financial condition of a business. *Other Assets* include accounts like: Deposits (utilities, telephone, etc.); Organization Costs (if you purchased your business); Accumulated Amortization of Organization Costs; Non-Current Receivables and Other Non-Current Assets. Unless you purchased your business, you probably only need to monitor your deposits so they

are released as soon as possible. If they are sitting on your *Balance Sheet*, they are '*Cash at Rest*'. Deposits do not earn interest (generally) and are not helping you grow your business.

In your *Chart of Accounts* your business's *Long-Term Liabilities* are accounted for by its debt obligations to other parties that last longer than one year. Remember the current portion of the debt obligation (due within a year) is accounted for in your *Current Liabilities*. *Long-Term Liabilities* include accounts like: Leases longer than one year (property, horses, etc.); Notes with a repayment term greater than one year; (loans from individuals, etc.); Land; Equipment (ranch equipment, tractors, ATV's, balers, etc.); Vehicles (ranch truck, horse trailer, etc.); Bank Loans and Other Long-Term Debt.

Management of Long-Term Liabilities is critical in evaluating a business's risk and its long-term solvency. There are three important ratios used to evaluate a business's risk and solvency. They all include a business's *Long-Term Liabilities*. *Long-Term Liabilities* need to be managed to keep a business growing or from becoming insolvent. All three ratios are important to a business's potential lender.

Debt Service Coverage is a measurement of a business's ability to generate enough cash flow to cover its debt obligations. This ratio needs to be greater than 1. If it isn't greater than 1, the business needs to improve its profit or reduce its long-term debt. *Debt Service Coverage* is *Net Operating Income* (Income before Taxes + Depreciation + Amortization + Interest) / *Total Debt Service* (Repayment of its debt obligations this year + Repayment Interest).

The *Debt Service Coverage* formula is:

$$\textbf{Debt Service Coverage} = \frac{\textbf{Net Operating Income}}{\textbf{Total Debt Service}}$$

Total Debt to Assets is a measurement of a business's relative obligations. The *Debt to Assets Ratio* is not a particularly exciting one, but it is very useful. The ratio needs to be less than 1. If it isn't less than 1, the business needs to reduce its debt load or put tighter controls on its purchasing. Loan institutions will interpret a high ratio as a 'highly debt leveraged business'. Businesses with high ratios are placing themselves at risk, especially in high interest rate

markets. Creditors are bound to get worried if a business is exposed to a large amount of debt and may demand that the business pay some of its debt back. *Total Debt to Assets* is *Total Liabilities* (current and long-term liabilities) / *Total Assets*.

The *Total Debt to Assets* formula is:

$$\textbf{\textit{Total Debt to Assets}} = \frac{\textbf{\textit{Total Liabilities}}}{\textbf{\textit{Total Assets}}}$$

Total Debt to Equity is a measurement of a business's leverage. This is a more stringent measurement of a business's financial risk than its '*Total Debt to Assets*' ratio. The '*Debt to Equity*' ratio is also called the '*Debt to Net Worth*' ratio. It quantifies the relationship between the capital invested by a business's owner(s) and/or investor(s) and the funds provided by its creditors - the higher the ratio, the greater the risk to a current or future creditor. A ratio greater than 1 means assets are mainly financed with debt. A ratio less than 1 means assets are mainly financed with equity. A lower ratio means your business is more financially stable and is probably in a better position to borrow now and in the future. However, an extremely low ratio may indicate that you are too conservative and you are not letting your business realize its full potential. If the ratio is greater than 1, the business probably needs to improve its profit, get additional investment or sell off unproductive assets. Creditors will interpret a high ratio as a 'highly debt leveraged business'. Businesses with high '*Debt to Equity*' ratios have the same interest rate exposure and creditor scrutiny as a business with a high '*Debt to Asset*' ratio. *Total Debt to Equity* is *Total Liabilities* (current and long-term liabilities) / *Shareholders Equity*.

The *Total Debt to Equity* formula is:

$$\textbf{\textit{Debt to Equity}} = \frac{\textbf{\textit{Total Liabilities}}}{\textbf{\textit{Shareholders Equity}}}$$

To be successful in a horse business does not require a finance education, but an understanding of what your financials are telling you 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.

In our next article we will continue to setup our *Chart of Accounts* and discuss *Equity* and *Expenses* in a horse business. Once we have our measurement system defined we will be able to explore how to measure and manage a horse business using good business principles and practices. A horse business needs to know if an invoice has any profit, or what expenses to manage to improve its bottom-line, or if a supplier is any good, or how to use its cash to grow the business. A good horse business management system will answer those questions.

Think – plan – organize – execute – make/save money.

Bob Valentine, Ph.D.
President
GenieCo, Inc.
636 E. Eisenhower Blvd., Suite 100
Loveland, CO 80537
1.888.678.4364
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.