Mind Your Own Business

In the previous two articles we have discussed the importance of defining a *Chart of Accounts* that reflects how you want to measure and manage your horse business. We also discussed the need for a horse business management system that enables you to get sufficient detail in each of your of main accounts through the use of *Subaccounts*. *Subaccounts* help you measure your business more accurately then just having 'catch-all' accounts.

For example, subaccounts will enable you to measure and manage:

- Your sources of income – *Western Training vs. English Training; Horse Rental vs. Trail Rides; etc.*
- Your vendors on price, terms, quality and delivery;
- Your return on marketing expense – *Promotion Materials vs. A Website Investment and Maintenance; etc.*

A list of potential horse business *Chart of Accounts* and *Subaccounts* is available on *www.equinegenie.com*.

In this article we will start to discuss the three most important financial documents in a business – the *Balance Sheet*, the *Income Statement* and the *Cash Flow Statement*. The information contained in each of these documents is from the financial information gathered during the operation of your horse business. The *Accounts* and *Subaccounts* identified on these documents are the ones you identified in setting up your *Chart of Accounts*. By-the-way, my favorite financial document is the *Cash Flow Statement*. Remember the *Cash Ratio (Horsemen's Ratio)* discussed in the first article – *'In an Equine Business Cash is KING'* and '***Profit is an accounting opinion, Cash is fact***'.

Unfortunately, many horse businesses are run out of their *Checkbook*. I call this '*Checkbook Accounting*'. I am sure you have heard the comic expression, '*I have checks, so I must have money'*. Running a business out of a *Checkbook* is a path to '*Out of Business'*. The problem with '*Checkbook Accounting*' is:

- First, your checkbook doesn't tell you the claims against the money in your business checking account – the feed store invoice, the truck payment, the horse lease, the breeding fee, etc. I have never met a person who can keep track of their business obligations in their head.

- Second, businesses rarely operate on an all cash basis. Most business consists of an action resulting in income that may include payments or a settlement in the form of an expense that may require payments. Unless you track all actions you really don't know how you are doing.
- Finally, businesses generally have to make complex financial decisions – can my business afford another employee, do I make money giving riding lessons, how many horses do I need to train to make a profit, etc. I don't know of anyone who can make these decisions intelligently without a good *Horse Business Management Software System*.

To be successful in business you need to have a complete picture of how your business is doing. You need information available to you as soon as a transaction happens if possible '*so nothing falls through the cracks*'. The information you use to file your taxes with the IRS is not the information you need to run your horse business effectively. Unfortunately, not many horse business owners use a good *Horse Business Management Software System*. They think record keeping is management. A horse's health record can contribute to a business's bottom line if it is part of a good horse business management system and not just a record keeping system. It is unfortunate, but accounting only systems, which are not business management system, cause business owners to revert to '*Checkbook Accounting*'.

Financial reports created by a good horse business management system show the business owner what the money they have in their checkbook really means. They tell important information such as:

- *How your horse business has performed financially over time;*
- *If you will be able to make payments on your outstanding loans;*
- *If you have sufficient funds to operate when business is down;*
- *If you have spent too much or too little on equipment;*
- *How you are doing getting paid by your customers;*
- *If you can afford to pay yourself and still meet all your other financial obligations.*

All the above questions are answered along with other similar questions in your *Balance Sheet*, *Income Statement* and *Cash Flow Statement*. Using all three financial documents together will help you build a stronger, better performing horse business.

First let’s discuss the Balance Sheet. The information on a *Balance Sheet* is not over a span of time. It just reflects what your business owns and what it owes on the day it is generated. The date on a *Balance Sheet* is the date it gives you a snapshot of keys facts about your business as of that date. The *Income Statement* and *Cash Flow Statement* are different. They are over a period of time and show how your horse business did over that time period. The Balance Sheet tells you how you ended up or where you are right now. The Balance Sheet as an individual financial document can tell you some interesting and important facts about your horse business.

- Is your horse business solvent – that is, are your assets at least equal to your liabilities? If your horse business was liquidated tomorrow what would have to show for all your hard work? The Balance Sheet won’t give you an exact answer, but if will give you a good indication of your business’s solvency. Remember from the first article:

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

- Is your horse business sufficiently liquid – that is, does it have enough cash and other liquid assets to cover its short term obligations? Are you going to be able to pay your bills immediately following the date on the *Balance Sheet*? Remember from the first article (*Horsemen’s Ratio*):

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

- What assets do you have in your horse business? Your Balance Sheet will show you how much money you have in cash and short term investments. It shows you how much you have tied up in supplies (Hay, Grain, Breeding Pipettes, etc.), inventory (Horses, etc.) and equipment (Saddles, ATV’s, etc.). It shows your how much you have tied up in what customer’s owe you (Receivables).
- Who has claims on your business assets? A Balance Sheet doesn’t name names, but it does show how much you owe creditors and how much belongs to the owners of the horse business.

It is always good to look at a *Balance Sheet* from two sequential dates. This will enable you to look for changes and trends from one date to the next.

Thanks to financial reporting standards every company has a similar *Balance Sheet* format. Yes, this includes a horse business. At the top or on the left hand side of a *Balance Sheet* is your horse business *Assets*. The *Assets* on your *Balance Sheet* shows what your horse business owns. Traditionally *Assets* are listed in the order of liquidity – how easily it would be to turn them into cash. Remember the liquidity analogy from the first article – *Cash is water, Investments and receivables are ketchup, and Inventory is Molasses*.

On the lower half or on the right side of a *Balance Sheet* is your horse business *Liabilities* and *Equity*. You're *Liabilities* on your *Balance Sheet* show claims on your *Assets* held by people outside your horse business. Traditionally *Liabilities* are categorized by how current they are. *Liabilities* that must be paid in the next twelve months are at the top. Your *Equity* shows what is left for you or, you and your shareholders after all other claims have been accounted for. *Equity* is typically categorized as *Common Stock* or *Paid in Capital*, and *Retained Earnings*. The *Common Stock* or *Paid in Capital* category represents all the money you have invested and/or other shareholders have invested to start your horse business. The *Retained Earnings* category is the accumulated profit or (loss) your horse business has earned, but not been withdrawn by you or any shareholder.

You might be asking by now, why does a *Balance Sheet* balance and what do *Equity* entries on a *Balance Sheet* really mean? *Equity* isn't something your horse business owes anyone except you and maybe some shareholders, yet it appears on the same side of the *Balance Sheet* with your *Liabilities* which shows what your horse business owes. The asset side of your *Balance Sheet* shows the money value of your horse business – cash in your bank, money that your customers owe you, physical objects such as horses you use in your business, equipment and maybe some intangible assets. The *Liability* and *Equity* side of your *Balance Sheet* is still numbers, but it represents the people your horse business owes (creditors) and the people who own the business (you and maybe some shareholders). It has been said that a *Balance Sheet* connects things (*Assets*) to people (*Liabilities and Equity*). Simply put, Equity is all the money that a company owes the owners of a business after everything it owes its creditors has been accounted for. Another way of saying it is: *Assets* equal *Liabilities* plus *Equity*. In the financial community this is called the *Basic Accounting Equation*. A business's *Balance Sheet* must satisfy the *Basic Accounting Equation*: *Assets = Liabilities + Equity*.

A typical *Balance Sheet* might look like the following example.

Best Horse Stables

Balance Sheet – May 14, 2012

Assets		
Cash and Equivalents		**$ 8,789**
Accounts Receivable		**$ 12,900**
Inventory		**$ 67,385**
Horses	**$ 57,000**	
Supplies	**$ 10,385**	
Notes Receivable		**$ 22,325**
Current Assets		**$ 111,399**
Gross Fixed Assets		**$ 425,456**
Vehicles	**$ 56,670**	
Equipment	**$ 27,980**	
Buildings	**$ 340,806**	
Accumulated Depreciation		**($ 67,000)**
Net Fixed Assets		**$ 358,456**
Other Assets		**$ 2,000**
Total Assets		**$ 471,855**
Liabilities		
Accounts Payable		**$ 5,828**
Taxes Payable		**$ 11,750**
Other Liabilities		**$ 2,250**
Current Liabilities		**$ 19,828**
Long Term Debt		**$ 245,567**
Vehicles	**$ 38,638**	
Equipment	**$ 17,456**	
Buildings	**$ 189,473**	
Total Liabilities		**$ 265,395**
Equity		
Paid In Capital		**$ 175,000**
Retained Earnings		**$ 31,460**
Total Equity		**$ 206,460**
Total Liabilities & Equity		**$ 471,855**

The categories on the *Balance Sheet* example might contain the following financial data.

- Cash and Equivalents – *Real Money, Certificates of Deposit (<90 days), Money Market Funds*
- Accounts Receivable – *What people owe your horse business or have promised to pay*
- Inventory – *Horses in your business used to make money and high value supplies*
- Notes Receivable – *Interest bearing loans your horse business has made to others*
- Current Assets – Total of Assets expected to be converted into cash in the next twelve months
- Gross Fixed Assets – *What you have tied up in vehicles, equipment, barns, etc.*
- Accumulated Depreciation – *Depreciation on your Fixed Assets (Depreciation will be discussed in-depth in a separate article*).
- Net Fixed Assets – *Gross Fixed Assets minus Accumulated Depreciation*
- Other Assets – *Long term Investments, Goodwill if you purchased the business, etc.*
- Total Assets – *Current Assets + Net Fixed Assets + Other Assets*
- Accounts Payable – *What you owe to vendors and suppliers for goods and services*
- Taxes Payable – *No explanation necessary*
- Other Liabilities – *Deposits received for services not yet performed or goods not yet delivered*
- Current Liabilities – *Total of all liabilities expected to be paid in the next twelve months, plus the portion of any long term debt to be paid in the next twelve months*
- Long Term Debt – *Debt with a repayment period greater than twelve months*
- Total Liabilities – *Current Liabilities + Long term Debt*
- Common Stock/Paid In Capital – *Money invested in your business*
- Retained Earnings – *Profit or (Loss) earned by your business, but not distributed*
- Total Equity – *Common Stock/Paid In Capital + Accumulated Retained Earnings*
- Total Liabilities & Equity – *Total Liabilities + Total Equity*

Applying some of the equations we learned in previous articles to our example *Balance Sheet* will glean the following valuable management information.

Current Ratio: 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.

$$\textit{Current Ratio} = \frac{\textit{Total Current Assets}}{\textit{Total Current Liabilities}} = \frac{\$\ 111{,}399}{\$\ \ 19{,}828} = 5.6$$

A *Current Ratio* of 5.6 is very acceptable. Your banker would be happy!

Quick Ratio: 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*.

$$\textit{Quick Ratio} = \frac{\textit{Cash + Investments + Receivables}}{\textit{Total Current Liabilities}} = \frac{\$\ \ 21{,}689}{\$\ \ 19{,}828} = 1.09$$

A *Quick Ratio* of 1.09 is acceptable. However, your banker might be concerned that 59% of your '*Quick*' funds to meet your current obligations are tied up in your customer receivables.

Cash Ratio: 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.

$$\textit{Cash Ratio} = \frac{\textit{Total Current Assets}}{\textit{Total Current Liabilities}} = \frac{\$\ \ \ \ 8{,}789}{\$\ \ 19{,}828} = 0.44$$

A *Cash Ratio* of 0.44 is _not_ acceptable. You and your banker should be concerned. However, if your tax liability is not immediately due, your *Cash Ratio* is 1.08, which is acceptable. The risk is predicated on when your taxes are due. You need to collect your customer receivables before your taxes are due and keep your receivables days outstanding shorter in the future. This is an example where '*Checkbook Accounting*' will get you in _big_ trouble.

Total Debt to Assets Ratio: *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, a 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.

$$\textbf{Total Debt to Assets} = \frac{\textbf{Total Liabilities}}{\textbf{Total Assets}} = \frac{\$\,265{,}395}{\$\,471{,}855} = 0.56$$

A *Total Debt to Assets* Ratio of 0.56 is very acceptable. Your banker would be very happy! It means that your horse business has the assets to support its debt. This will help to hopefully solve the short term *Cash Ratio* problem if necessary. However, bankers do not like to loan money to pay tax bills. If they do the interest on a tax loan is generally not very favorable.

Total Debt to Equity: *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.

$$\textbf{Debt to Equity} = \frac{\textbf{Total Liabilities}}{\textbf{Shareholders Equity}} = \frac{\$\ 265{,}395}{\$\ 206{,}460} = 1.28$$

A *Total Debt to Assets* Ratio of 1.28 is not going to make your banker happy. It means that your horse business is financed using more debt than investment. This could be a problem if you need a loan to solve your *Cash Ratio* problem. You should look at how to increase sales and maybe sell some unproductive assets.

In summary, as you have seen, your horse business *Balance Sheet* communicates some important information, like what your business owns, what it owns, and does it have the right balance of investment and debt, etc. However, it also leaves out a lot. It doesn’t tell you if your horse business made money last year. It doesn’t tell you where your horse business’s cash came from or if your business has a healthy cash flow. How to acquire, understand and use this missing information will be discussed in our next couple of articles when we examine an *Income Statement* and a *Cash Flow Statement*. Remember the value in these financial documents starts with a well thought out *Chart of Accounts* that reflects what your think is important in measuring and managing your horse business.

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.

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

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