

GETTING STARTED IN THE THOROUGHBRED HORSE BUSINESS: A REVIEW OF SOME BASIC ACCOUNTING PRINCIPLES

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CASE DESCRIPTION

This case, for beginning accounting students, reinforces some common accrual accounting concepts in an interesting setting. The body of the case is also available in CD version with a dramatized story and summaries of the data for students to refer to while answering the questions (to get a CD, contact the author directly). The key concepts include revenue and capital expenditures, product and period costs, profit and loss, cash flows, fixed assets and depreciation, inventory costing, indirect costs, cost allocation and cost of goods sold. Due to the concepts covered, it is appropriate to use during the second half of the course after students have been exposed to fixed assets, inventory, profit and loss and cash flow reporting. The case should take about 30 to 45 minutes of class time with about two hours of out-of-class preparation for each of the three sets of discussion questions.

SYNOPSIS

The case centers on the breeding and racing operations of a small Thoroughbred horse business whose owner has little business or accounting knowledge. The business has two distinct operations, racing and breeding. Students discover that the Thoroughbred breeding industry is primarily a manufacturing business with the mares serving as production equipment and the foals serving as inventory. Racing operations are similar to many other businesses with fixed assets (racing stock) and operating costs

(board, transportation, vets, race entry fees, jockey purses, etc.). In this case, the owner financed her operations with a large bank loan so the concept of cost allocation and indirect costs for interest are also introduced. Students are asked to identify the cash flows, list the product and period costs, recommend a depreciation policy for each operation and reconcile the cash flow to income.

Instructors are given sufficient background information on accounting and reporting issues in the Thoroughbred industry to allow adequate feedback and guidance to the students. Since most Thoroughbred horse business are not public companies, they primarily report on an income tax basis. Some basic, relevant tax issues are presented as background for instructors. Short summaries of the history of the Thoroughbred breed, naming foals and the Triple Crown of racing are provided for interest.

The case is also available on CD with a dramatized story line and appropriate data summaries for use by students (contact the author directly to obtain the CD from which copies can be made).

Getting Started in the Thoroughbred Horse Business: A Review of Some Basic Accounting Principles

Over dinner, Carol and her former college roommate Gina were discussing their lives and interests since college. Both had grown up in the Bluegrass Region of central Kentucky. Carol had pursued her CPA career in Chicago and had recently returned to Lexington to take another accounting job. Gina, meanwhile, had worked in advertising for a local agency while trying to pursue her real interest – Thoroughbred horses. She already owned several Thoroughbreds and had been doing some limited breeding and racing. In January 2005, Gina was seriously considering leaving her marketing career and becoming a full time Thoroughbred breeder and trainer.

“Gina, why did you want to get involved in the horse business? I thought that your interest was advertising.” asked Carol.

“Carol, if I have to tell you, you probably won’t understand anyway” teased Gina. “Really, though, the satisfaction comes from daily interaction with high-strung and sensitive animals plus seeing the beauty and grace of one of the world’s fastest animals. All Thoroughbreds are descended from Arabian and Turkish racing breeds. Even though they can only hold their top speed for about one-quarter of a mile, they can exceed 40 miles per hour for a mile or more. There’s a reason why The Kentucky Derby is called the fastest two minutes in sports!” [See Appendix B: History of the Thoroughbred Horse]

“And”, continued Gina, “The business aspects of it are also a challenge since a lot of people can’t make it in this industry. There’s a saying in the Thoroughbred business: The only way to end up with \$1 million in the Thoroughbred horse business is to start with \$10 million! With boarding costs running from \$30 to \$40 per day and training costs averaging \$75 a day, you can see that you need a lot of money just for daily operations. Also, vet costs average about \$300 a month even for healthy horses and I’m paying around \$100 a month to the blacksmith for each horse.”

“So your goal is to win the Kentucky Derby and make a lot of money?” quizzed Carol.

“No, on either count”, laughed Gina. “Only a few big-time, select breeders and trainers reach the performance level of the Kentucky Derby although everybody hopes to breed the next Secretariat. That’s very expensive company to keep. Although every breeder and owner secretly hopes that will happen, realistically, it won’t. Many Thoroughbreds never race at a distance beyond one mile and all of the Triple Crown races are longer than that.” [See Appendix D: The Triple Crown of Racing]

“My racer, Rockin’ Robin’s best distance is about eight furlongs, which is one mile. Actually, he did quite well at that distance in 2004 which was his first racing season. Although his previous owner did some training, we didn’t start our training until early January. He raced for the first time in May and finished first or second in all five of his starts. Here’s a list of his finishes and purse amounts. [See Appendix A: Race Results]. Race payoffs are called “purses” since, in the very early days of racing, the winning money was hung in a purse at the finish line and the winning jockey took it all. In modern racing, the winner gets about 60% of the purse, 2nd place gets 20%, 3rd gets 12%, 4th gets 6% and 5th gets about 2%.”

“Let’s see if I understand all of this” interjected Carol. “‘TR’ must mean ‘track’ and I’m guessing that CD means Churchill Downs and KEE means Keeneland. Right?”

“You know more about racing than you’ve admitted”, laughed Gina.

Carol continued: “He’s raced at distances from 6 ½ to 8 furlongs. Since you said that 8 furlongs is a mile, his best distance is between three-fourths and one mile. ‘TR Cond’ must mean track conditions. What do ‘FP’ and ‘TF’ mean?”

Gina explained: “FP means finish position and TF means total horses in the field. Look at September 4. Robin finished first out of seven horses. The total purse was \$56,000. As winner, we got 60% of that amount. You can see that with his five first or second place finishes last year, we’ve gotten a pretty good return on our \$200,000 investment.”

“One last explanation here”, said Carol. “I don’t understand the lingo under ‘Race type’.”

“That’s one of the most confusing parts of this business since there are so many different race types. It takes a trainer with a lot of experience to know what’s best for your horse,” explained Gina. “Horses who have never won a race are called Maidens and there are special races for them. As you can see, Robin’s first two races were Maiden races.”

Gina continued: “Allowance races permit some horses to carry less weight than others based on their racing history. Colts (males) can’t carry over 126 pounds and fillies (females) can’t carry over 121 pounds including the jockey’s weight. Stakes races are the most prestigious ones and, as a result, pay the most money and attract the best horses. We were really lucky to win that stakes race in December. Everything broke right for us that day!”

“How big can the race purses get?” asked Carol.

“As your horse improves, you want to move up in class to race for larger purses. Last year Robin moved up from a purse of \$47,000 in May to \$100,000 in December” replied Gina. “That’s probably about as high as we’ll get. But, if you’re talking about the highest levels of racing, the Preakness and Belmont Stakes are over \$1 million and the Kentucky Derby purse is now well over \$2 million.”

“It looks like you made some good money in racing last year” observed Carol.

Gina countered: “Well, we had five good payoffs but there are a lot of expenses involved with racing beyond the training costs. It’s common in this business for the trainer and jockey to split 20% of the winnings and the stable where Robin boards gets 3%. Also, we paid about \$2500 in race entry fees and spent about \$1200 on transportation to the races.”

“When’s Robin’s next race?” asked Carol. “I can’t wait to see him in action!”

“Well, there may not be another race for Robin. I’m considering selling him and concentrate on the breeding operations”, replied Gina. “It’s a different type of business that I find more satisfying and I also think it’s where I can make the most money. We’ve been lucky with Robin’s racing career; he’s done well as a two-year old. But, generally, there’s as much as a five-year lag before you get any racing revenue if you breed and train your own racing stock. Most Thoroughbreds don’t do a whole lot of racing until they are three-year olds.”

“Oh, I didn’t know that you were also doing some breeding. That sounds intriguing. Tell me about it” said Carol.

“In late 2003, I bought a four-year old mare, Lady Delight, for \$300,000. She was ‘in-foal’ which means she was pregnant. The foal, Dan D Dancer, was born in March 2004 and he’s now a yearling. I bred Lady Delight again last year and that foal is due in March”, explained Gina.

“Can you explain the age designations for Thoroughbreds? I’ve never understood that whole thing” asked Carol.

“For racing and breeding, all thoroughbreds have the same birthday – January 1”, explained Gina. “At birth (called foaling), all thoroughbreds are called foals until they’re weaned at about four to five months. They’re then called weanlings until their first January 1 when they become yearlings. After their second January 1, they are called two-year olds and so forth. Breeders time their mares to give birth early in the year which is why breeding season is February through April. They want the foals to be as old as possible by their first January 1. For example, The Kentucky Derby is the premiere race for three-year olds. For that race, colts and fillies born in January (three years earlier) will have three to four extra months of maturing and training over foals born later in the spring of that year. That’s a big advantage!”

“What stallion did you breed to Lady Delight? And, isn’t that expensive?” asked Carol.

“Very successful stallions, like Empire Maker (winner of the 2003 Belmont Stakes), get a \$100,000 breeding fee. Storm Cat, one of the strongest sires in history gets \$500,000! Obviously, I had to spend a lot less than that and paid \$26,500 for a decent, local stallion. Most breeding contracts guarantee that the foal will be born alive, stand on its own and nurse or else the fee is waived.” explained Gina.

“Okay, you own a pregnant mare and a foal, oh sorry! a yearling. I guess the vet bills go up during foaling, right?” queried Carol.

“Yes, but not as much as you might think. If everything goes okay, which ours did, you can get by for about an extra \$500. But, of course, now you have another horse incurring daily boarding fees and monthly vet costs”, continued Gina. “The only break here is that before they’re weaned, daily boarding costs are only \$15 since the foals share a stall with their mother.”

She continued: “We’ll take Dan D to this summer’s auctions. In March, we’ll start the whole process over again when the second foal is due. The goal is to make enough money on one or two foals to expand the breeding operation by buying more mares. Eventually, if you do really well, you can buy your own farm and expand the breeding even more. Many farms board other people’s horses to pay the bills while they wait for the bigger payoffs from breeding. As you’ve figured out, I’m boarding my horses on someone else’s farm since I don’t own a farm yet!”

Carol returned to an earlier topic: “So, you need to make enough from selling Rockin’ Robin and Dan D Dancer to finance another mare. Is that possible? How much can you get for Robin and Dan D?”

“Since the auctions aren’t always predictable, I really wasn’t counting on Dan D so much. I was hoping to make enough on Robin to pay back part of the loan and buy a new mare”, replied Gina. “Based on early conversations with other owners, we think he’ll bring around \$750,000”.

“Wow, you’re rich!” exclaimed Carol. “Do you need a partner?”

“Not so fast” cautioned Gina. “From that price I’ve got to pay a 10% agent’s commission, a 5% trainer’s commission and sales entry and prep fees of about \$3000. I don’t get to keep all of it.”

“Now that I know a little more about Thoroughbred horses, let’s talk about you making money in this business”, said Carol. “You said you wanted to get out of racing and concentrate on breeding. So, you must have run the numbers on each activity and picked the one with the biggest return. Right?”

“Okay, you caught me” laughed Gina. “I didn’t keep very good records but I think that I did okay overall. At least I was able to pay my bills every month.”

“Thank you for not asking” continued Gina, “But as you know, I didn’t really have the kind of money needed to get started in this business. It helps to have relatives in the banking business and to have good co-signers for a loan. I borrowed \$500,000 early last year to finance my horse operations. The previous owners of Rockin’ Robin and the mare let me delay payment to them until the loan came through.”

“You’re making payments on debt of \$500,000?” asked Carol. “You have to be making a lot of money!”

“Actually, it’s a demand loan so I’m only paying the interest right now” countered Gina. “The interest is prime plus 4%, payable quarterly.”

“You know, Gina, if you knew a good CPA, they’d be able to tell you whether you made or lost money on your breeding and racing operations. Yes, if you only knew a CPA that could help you” mused Carol.

Discussion Questions – Part I: Racing Operations – cash flows, profit/ loss, capital expenditures, depreciation, gross profit, net profit.

You are a CPA advisor helping Gina determine her financial success in the racing part of her business. Provide complete responses to the following items.

1. Discuss, in general, the different ways that a business owner might determine how well their business has performed.
2. Compute Gina’s cash inflows and outflows from the racing operations for last year (2004). Show each inflow and outflow separately.

3. Using accrual accounting, identify the types of revenues and costs related to Gina's racing operations. Classify each of the costs as either a capital expenditure or revenue expenditure (expense). Explain your answers.
 4. Explain how the capital expenditures identified in answer I-3 would be treated for accounting purposes in the current and future years. Include an estimate of how much of each of the capital expenditures should be expensed in 2004. Be specific
 5. Compute Gina's accrual accounting income or loss from the racing operations for last year. Prepare a detailed income statement. Present any supporting calculations that are needed.
 6. In general, do cash flows equal accounting income or loss? Why or why not? Reconcile (explain the differences) your answers from questions I-2 and I-5.
7. If Gina sells Rockin' Robin in July 2005 for \$750,000, compute her gross and net profit on the sale. Show any supporting calculations.

Discussion Questions – Part II: Breeding Operations – cash flows, profit/ loss, capital expenditures, depreciation, gross profit, net profit.

1. Compute Gina's cash inflows and outflows from the breeding operations for last year (2004). Show each inflow and outflow separately.
2. Using accrual accounting, identify the types of revenue and costs related to Gina's breeding operations. Classify each of the costs as either a capital expenditure or revenue expenditure (expense). Explain your answers.
3. Explain how the capital expenditures identified in answer II-2 would be treated for accounting purposes in the current and future years. Include an estimate of how much of each of the capital expenditures should be expensed in 2004. Be specific.
4. Compute Gina's accrual accounting income or loss from the breeding operations for last year. Prepare a detailed income statement. Present any supporting calculations that are needed.
5. Reconcile (explain the differences) between your answers in 1 and 4.

Discussion Questions – Part III: Combined Operations – profit/ loss, expense classification.

1. Compute Gina's overall, combined income or loss from her Thoroughbred horse operations for last year (2004). Prepare a detailed income statement showing the separate types of revenue and expenses (e.g. operating, non-operating, etc). Present any supporting computations that are needed.
2. Make a recommendation to Gina concerning the future of her racing and breeding operations. Make suggestions as to which activities to continue pursuing versus those activities to stop doing. Consider other criteria besides cash flows and profit or loss.

APPENDIX A
Race Results – Rockin’ Robin
2004

Horse	Race	Date	TR	Race type	Dist	TR Cond	Jockey	FP/TF	Purse
Rockin’ Robin (2002) b.c. Into training oct 03	1	04 May 02	CD	Maiden-Special Weight	6.5f	Fast	K. Rider	2/6	47,000
	2	06 July 02	CD	Maiden-Special Weight	8f	Fast	K. Rider	1/7	47,000
	3	04 Sept 02	TP	Allowance	8f	Fast	K. Rider	1/7	56,000
	4	15 Oct 02	KEE	Listed Race	8f	Fast	K. Rider	2/8	65,000
	5	01 Dec 02	CD	Stakes Race	8f	Fast	K. Rider	1/8	100,000

b. c. – bay colt

Tracks: CD – Churchill Downs; TP – Turfland Park; KEE – Keeneland

Distance: f – furlong (1 furlong = 1/8 mile)

APPENDIX B
History of the Thoroughbred Horse

The Thoroughbred breed of horse traces its ancestry back more than 300 years to three foundation stallions - the Darley Arabian, the Godolphin Arabian and the Byerly Turk. These stallions were imported to England from the Mediterranean Middle East around the turn of the 17th century and bred to the stronger, but less precocious, native mares. The result was an animal which could carry weight with sustained speed over extended distances.

In height, the Thoroughbred averages a little over 16 hands (1 hand = 4 inches) to the withers and weighs approximately 1,000 pounds. The Thoroughbred's conformation, or physical makeup, enables it to reach speeds up to 40 miles per hour. At that rate, the Thoroughbred covers nearly 60 feet per second.

The Thoroughbred's rear legs act much like springs as they bend and straighten during running. This tremendous "spring power" helps thrust the Thoroughbred forward as its front legs provide "pull." The head and long neck also help to make running smooth and rhythmic. The neck moves in synchrony with the forelegs, aiding the Thoroughbred in its forward motion and extending the "arc of flight" - the time the Thoroughbred literally is airborne.

Blessed with agility, grace, speed, stamina and courage, Thoroughbreds are ideally suited for any number of disciplines beyond the racetrack. Thoroughbreds compete at the highest levels of international competition in eventing, show jumping and dressage, and also make outstanding hunters, steeplechasers, barrel racers and polo

mounts. They are also used by mounted police patrols and recreational riders who appreciate their intelligence and versatility. (Source: The Jockey Club).

APPENDIX C Naming Thoroughbreds

Before choosing a name, owners send their proposed names to the Jockey Club. The name is checked for similarity against their registry of over 430,000 names and compliance with the 15 rules governing names including such rules as less than 18 characters and no business or suggestive meanings.

Many names are derived from personal and pop culture connections. However, the most popular naming technique is through incorporating name combinations or some other reference to the foal's pedigree. For example: Alphabet Soup (out of the mare Illiterate), Flat Fleet Feet (by Afleet out of Czar Dancer) and Prenup (by Smarten out of Homewrecker). (Source: The Jockey Club).

APPENDIX D Triple Crown of Racing

This series of three premiere races for three-year old Thoroughbreds begins with the Kentucky Derby which is run over 1 ¼ miles at Churchill Downs on the first Saturday in May. The second leg is the Preakness Stakes which is run two weeks later over the 1 3/16 mile course at Pimlico. Three weeks later is the final leg, the Belmont Stakes run over a 1 ½ course at Belmont Park. This final race is referred to as “the test of champions” since this is the longest distance that Thoroughbreds will ever race.

Sir Barton (1919) was the first of 11 triple-crown winners. The most recent winner, Affirmed, accomplished that difficult feat in 1978. (Source: The Bloodhorse).

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