Mind Your Own Business

In this article we are going to discuss how the three key financial statements fit together and how a change in one affects the others. This will enable you see the *'Big Picture'* at a glance. How your financial statements fit together isn't magic. In fact, it is quite simple! When you know the connections it will be easier for you to communicate with an accountant. In fact, you may not even need an accountant, or at least spend less money on one to look over your financials. What you will learn is some of what has already been discussed in previous articles. For example, the *Income Statement* has nothing to do with the cash coming into a business or the cash going out.

Because financial statements are fragmented the connection between them is not obvious. Comparing a January 1st *Balance Sheet* to its December 31st *Balance Sheet* doesn't tell you why you have more *Cash and Equivalents* now then at the beginning of the year or why your *Retained Earning* have increased.

Balance Sheet Comparison

Best Horse Stables

Balance Sheet – January 1, 2012

Assets		
Cash and Equivalents	$	28,567
Accounts Receivable	$	12,900
Inventory	$	67,385
Horses $ 57,000		
Supplies $ 10,385		
Notes Receivable	$	22,325
Current Assets	$	131,177
Gross Fixed Assets	$	425,456
Vehicles $ 56,670		
Equipment $ 27,980		
Buildings $ 340,806		
Accumulated Depreciation	($	67,000)
Net Fixed Assets	$	358,456
Total Assets	$	489,633
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	$	49,238
Total Equity	$	224,238
Total Liabilities & Equity	$	489,633

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Balance Sheet – December 31, 2012

Assets		
Cash and Equivalents	$	80,723
Accounts Receivable	$	7,800
Inventory	$	63,265
Horses $ 57,000		
Supplies $ 6,265		
Notes Receivable	$	9,850
Current Assets	$	161,638
Gross Fixed Assets	$	425,456
Vehicles $ 56,670		
Equipment $ 27,980		
Buildings $ 340,806		
Accumulated Depreciation	($	104,701)
Net Fixed Assets	$	320,755
Total Assets	$	482,393
Liabilities		
Accounts Payable	$	2,435
Taxes Payable	$	14,548
Other Liabilities	$	2,250
Current Liabilities	$	19,233
Long Term Debt	$	219,929
Vehicles $ 29,622		
Equipment $ 12,194		
Buildings $ 178,113		
Total Liabilities	$	239,162
Equity		
Paid In Capital	$	175,000
Retained Earnings	$	68,231
Total Equity	$	243,231
Total Liabilities & Equity	$	482,393

You will need to look at your *Income Statement* or your *Cash Flow Statement* to explain the difference between the two Balance Sheets. Remember, a Balance Sheet is only a snapshot of a company's financial condition at a particular point in time. Unfortunately, the *Balance Sheet*, *Income Statement* and *Cash Flow Statement* are not set up to answer *cause-and-effect* questions. Without understanding how to create a '*Financial Scoreboard'* determining the *cause-and-effect* between statements is not easy. However, after you do understand the *cause-and-effect* connections you will see the *'Big Picture'* and that is the purpose of this article.

The *Income Statement* explains some of the differences. The *Net Profit* number, for example, explains the increase in the *Retained Earnings (*$49,238 + $18,993 = $68.231*)*. The *Depreciation* on the *Income Statement* is the one year net of the *Accumulated Depreciation* on the *Balance Sheet (*$104,701 - $67,000 = $37,701*).*

Income Statement

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Income Statement – December 31, 2012

Sales			
Training	$	194,400	
Board	$	172,800	
Commission	$	36,000	
Showing	$	49,750	
Transportation	$	11,112	
Total Sales	$	464,062	*100%*
Expenses			
Forage (Hay)	$	46,253	
Grain	$	19,447	
Supplements	$	23,390	
Farrier	$	61,900	
Veterinarian	$	20,650	
Bedding	$	73,840	
Barn Labor (Contract)	$	52,359	
Salaries	$	93,481	
Total Expense	$	391,320	*84.3%*
Operating Profit	$	72,742	*15.7%*
Non-operating Expenses			
Income Tax	$	14,548	
Interest & Other	$	1,500	
Depreciation	$	37,701	
Total Non-Operating	$	53,749	*11.6%*
Net Profit	$	18,993	*4.1%*

The other numbers on the *Income Statement* don't explain much. Remember – the *Income Statement* contains no *Cash* information, so it isn't going to explain why there is more *Cash* at the end of the year than at the beginning. Because the Income Statement contains no *Cash* information it will not explain why *Receivables* and *Inventory* decreased during the year. The *Cash* answers are found on the *Cash Flow Statement*.

Cash Flow Statement

Best Horse Stables

Cash Flow – December 31, 2012

Total Sales	$	464,062
Accounts Receivable	$	5,100
Notes Receivable	$	12,475
Customer Collections	$	481,637
Forage (Hay)	($	46,253)
Grain	($	19,447)
Supplements	($	23,390)
Bedding	($	73,840)
Inventory	$	4,120
Supplies	($	158,810)
Farrier	($	61,900)
Veterinarian	($	20,650)
Barn Labor	($	52,359)
Salaries	($	93,481)
Accounts Payable	($	3,393)
Expenses	($	231,783)
Interest	($	1,112)
Other Liabilities	($	388)
Income Tax	($	11,750)
Non-Operating Expenses	($	13,250)
Cash Flow Operations (OCF)	$	77,794
Long Term Debt	($	25,638)
Cash Flow Financing (FCF)	($	25,638)
Change In Cash	$	52,156
Beginning Cash	$	28,567
Ending Cash	$	80,723

Looking at the *Cash Flow Statement* you can see why *Receivables* and *Inventory* decreased during the year. *Accounts Receivable* decreased because $5,100 was collected during the year. Inventory decreased because $3,393 was consumed during the year.

You can account for almost every single change from one *Balance Sheet* to the next by taking the appropriate numbers from the *Income Statement* and the *Cash Flow Statement* and adding or subtracting them.

Unfortunately, many accountants don't talk about how all the numbers fit together. In fact, they rarely explain the connections to business owners and they haven't learned to present financial statements in a way that makes the connections clear.

An IBM executive, Lou Mobley, invented a way to understand the connections. He named it the *Continuity Equation*. The *Continuity Equation* is used to create a simple one page Matrix that displays the *Beginning Balance Sheet*, the *Income Statement*, the *Cash Flow Statement* and the *Ending Balance Sheet*. The matrix is called the '*Financial Scoreboard'*.

Financial Scoreboard

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Balance Sheet – January 1, 2012		Income Statement December 31, 2012		Cash Flow – December 31, 2012		Balance Sheet – December 31, 2012	
Cash and Equivalents	$ 28,567			Cash Change	$ 52,156	Cash and Equivalents	$ 80,723
Accounts Receivable	$ 12,900	Sales	$ 464,062	Collection (OCF)	$ 469,162	Accounts Receivable	$ 7,800
Inventory	$ 67,385	Supplies	$ 162,930	Supplies (OCF)	($ 158,810)	Inventory	$ 63,265
Notes Receivable	$ 22,325			Notes Receivable (OCF)	$ 12,475	Notes Receivable	$ 9,850
Net Fixed Assets	$ 131,177					Net Fixed Assets	$ 161,638
Gross Fixed Assets	$ 425,456					Gross Fixed Assets	$ 425,456
Depreciation	($ 67,000)	Depreciation	$ 37,701			Accumulated Depreciation	($ 104,701)
Net Fixed Assets	$ 358,456					Net Fixed Assets	$ 320,755
Total Assets	$ 489,633					Total Assets	$ 482,393
Accounts Payable	$ 5,828	Expenses	$ 228,390	Expenses (OCF)	($ 231,783)	Accounts Payable	$ 2,435
Taxes Payable	$ 11,750	Income Tax	$ 14,548	Income Tax Paid (OCF)	($ 11,750)	Taxes Payable	$ 14,548
Other Liabilities	$ 2,250	Interest & Other	$ 1,500	Interest & Other (OCF)	($ 1,500)	Other Liabilities	$ 2,250
Long Term Debt	$ 245,567			Borrow (Payback) (FCF)	($ 25,638)	Long Term Debt	$ 219,929
Paid In Capital	$ 175,000					Paid In Capital	$ 175,000
Retained Earnings	$ 49,238	Net Profit	$ 18,993			Retained Earnings	$ 68,231
Liabilities + Equity	$ 489,633					Total Liabilities + Equity	$ 482,393
				Operating Cash Flow	$ 77,794		

The *'Financial Scoreboard'* should be arranged with the *Beginning Balance Sheet* on the left side of the page, the *Income Statement* next to it, the *Cash Flow Statement* next to that and the *Ending Balance Sheet* on the right side of the page.

There are two secrets to making the *'Financial Scoreboard'* work:

1. You have to do some rearranging so that related numbers line up horizontally. For example; *'Change in Cash'* should be at the top of the *Cash Flow Statement* so that it aligns with the *'Cash and Equivalents'* line on the Balance Sheets.
2. The signs of the numbers will be different depending on whether you are adding them up vertically or horizontally. For example, when you are adding up (*Vertical Math*) the *Cash Flow*

Statement, collection is a positive number since it represents *Cash* coming in. When you are figuring out the *Ending Balance Sheet* you are adding sales (*Horizontal Math*) to the *Beginning Balance Sheet Receivables* and subtracting collection to get the *Ending Balance Sheet Receivables*. In this case collection is treated as a negative number.

It is easy to get confused at first, but the different signs reflect common sense logic. The logic is that *Financial Statements* show *cause-and-effects* depending on where they show up on the financials. To check your logic on any given item you can use a '*Financial Scoreboard' Decoder*. The *Decoder* helps you determine if you should add or subtract when you are using *'Horizontal Math'*.

Financial Scoreboard Decoder

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Balance Sheet January 1, 2012	Income Statement December 31, 2012	Cash Flow December 31, 2012	Balance Sheet December 31, 2012
+ Cash and Equivalents		+ Cash Change	= Cash and Equivalents
+ Accounts Receivable	+ Sales	- Collection	= Accounts Receivable
+ Inventory	- Supplies	+ Supplies	= Inventory
+ Notes Receivable		+ Notes Receivable	= Notes Receivable
+ Gross Fixed Assets			= Gross Fixed Assets
+ Depreciation	+ Depreciation		= Depreciation
+ Accounts Payable	+ Expenses	- Expenses	= Accounts Payable
+ Taxes Payable	+ Income Tax	- Income Tax Paid	= Taxes Payable
+ Other Liabilities	+ Interest & Other	- Interest & Other	= Other Liabilities
+ Long Term Debt		- Borrow (Payback)	= Long Term Debt
+ Paid In Capital			= Paid In Capital
+ Retained Earnings	+ Net Profit		= Retained Earnings

Some of the signs are different than they are in *'Vertical Math'* because we are looking at the effect of changes on individual line items. For example, *Accounts Payable* is increased by whatever *Expense* is incurred on the *Income Statement*. *Accounts Payable* is decreased by the *Expense* paid on the *Cash Flow Statement*.

What good does it do to put all these number together on one page? The *'Financial Scoreboard'* is not a replacement for the three traditional financial statements. It is just another way of arranging the numbers. The *'Financial Scoreboard'* does have several advantages over the traditional financial statement presentations.

- The *'Financial Scoreboard'* lets you see the *'Big Picture'* of your business's financial condition at a glance. It is like an executive summary.
- The *'Financial Scoreboard'* shows *cause-and-effect* relationships between the three traditional financial statements. You can understand exactly how and why your *Balance Sheet* differs from your *Balance Sheet* from a preceding period. The *'Financial Scoreboard'* makes it easy to track progress against goals.
- The *'Financial Scoreboard'* helps you fill in the gaps. If you don't get a direct *Cash Flow Statement* from your accountant or your accounting software you can create one using the *'Financial Scoreboard'*. *The equineGenie Horse Business Management Software provides both a Cash Flow Statement and a 'Financial Scoreboard'*.
- The *'Financial Scoreboard'* is a powerful planning tool. You can plug in projected figures for a coming period of time and see what happens to other items on the *'Scoreboard'*.
- The *'Financial Scoreboard'* is helpful in detecting errors, incompetence and ever fraud. If things do not add up you know there are mistakes in your traditional financial statements.

A 'Financial Scorecard' works for any size company anywhere. At this point you should have a better understanding of your financial statements and you should be more confident in your ability to interpret them. However, understanding and interpretation are only the first steps. In the coming articles you will be learning to use your financial statements to manage your business. We will look at the key numbers and ratios you can pull from your financials. We will use the *'Financial Scoreboard*' to not just understand your business's financial performance, but to manage it and to set goals and reach them.

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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