Video Transcript

Introduction to Financial Statements Part 1: Balance Sheets

Topics

- Part 1 of a 4-part series that introduces the primary financial statements companies report to their stakeholders.
- Introduces the purpose, structure, and uses of balance sheets.

Transcript

Welcome to Part 1 of a 4-part series that introduces the primary financial statements companies report to their stakeholders. We will be introducing numerous important terms and concepts in this series, so you might be thinking you will need to take plenty of notes to ensure you get off to a good start. Wrong!

Put away your pen and paper! You only need to understand the big picture at this point.

In fact, every term and concept in this series will be introduced again and developed more thoroughly during the first half of the course. And along the way, you'll complete numerous exercises that will help you internalize these terms and concepts.

So now you may be thinking you've found a short cut: Skip these videos. Wrong again!

You can do that and probably perform well in the course. But there are two reasons your journey will be easier and more enlightening if you watch this series.

First, it will help you frame terms and concepts as they are introduced, because you'll understand how they relate to the bigger picture and to concepts covered in later modules.

Second, it will be much easier for you to comprehend the later discussions if it's your second exposure.

One more point before we get started. We recommend you view the four videos over four sittings. Even though you only need to understand the big picture, it's a pretty big picture to grasp in one sitting.

So sit back, relax, don't sweat the details and enjoy the series, starting with this video, where we focus on balance sheets.

We begin with four questions?

First, what resources do you control today that arose from past activities and will benefit you in the future? For example, do you own a smartphone or lease a car? Do you have the skills to land a job in marketing? Our focus is on resources you have today where these resources arose from past activities. Here's today. Here's the past. And we're looking at economic activities in the past. Thus, we're interested in the resources you still control today because of past economic activity. So if you bought a car back here and then sold it here, well it's not going to be on your balance sheet today.

Our second question is who has a claim on these resources? You do, of course. But so might others. For example, if you have a car loan, the bank, or another party who gave the loan to you, well it has a claim on the car, meaning they can seize the car if you fail to meet your loan obligations.
Our third question is how might these resources affect decisions by you and others? For example, do you have enough resources to buy a new smartphone or convince a bank to give you a loan or convince a company to give you a job in marketing?

Our fourth question is how reliably can these resources be measured? And, thus how useful are these measures for decisions by you and others? For example, reliably measuring how much cash you have, that's relatively easy, but reliably measuring and communicating the value of your marketing skills to a prospective employer, well that's much more challenging.

Next, we'll explain how these questions relate to the purpose of balance sheets and to their primary elements.

The purpose of a balance sheet is to help investors and other financial-statement users assess companies' financial positions. It does so by reporting the resources a company owns or controls on a reporting date, its assets and the claims stakeholders have on these resources. At each reporting date, there is a very simple equation: Assets = Claims on assets.

Your cash and car are examples of assets: both are resources you control that will provide future benefits.

There are two types of claims: creditors' claims, called liabilities, and owners' claims, called owners' equity. So, under claims, down here, we have liabilities and owners' equity.

The result is the balance sheet equation: Assets = Liabilities + Owners' Equity, which we will call BSE, Balance Sheet Equation. This is the most important equation we're going to study in the entire course. Almost all the concepts in the course will tie back to this equation.

Liabilities are obligations to make agreed upon future payments or otherwise relinquish assets or provide services. That's a mouthful. Let me give you an example. Your outstanding college loans and utility bills are examples of liabilities. You have an obligation to make the payments.

Owners' equity, well that's a residual claim on the assets. This means the owners have a claim on the remaining assets once the liabilities are settled.

Let me give you an example. If you have $1,000 of assets at a reporting date, so on any particular date, and $300 of liabilities, well then your owner's equity is $700. That's how much you'll have left of the $1,000 after you pay off the $300 in liabilities.

Importantly, some very valuable resources, well, they don't get recognized on balance sheets, meaning they aren't reported on balance sheets. Similarly, some very big obligations, well, they don't get recognized. Why not?

Because accounting standard setters have concluded these assets and liabilities can't be measured reliably enough to get on balance sheet. For example, your marketing skills will be a very valuable resource if you seek a marketing job, but they can't be measured reliably enough to be recognized on your balance sheet.

Next, we'll briefly explain how questions similar to those we posed earlier about your financial position relate to questions we will address throughout the course for real companies.

First, what resources does the company control at the reporting date that arose from past activities and will benefit its future? That is, what assets does it have at the reporting date, including those that can and cannot be measured reliably enough to be recognized on the balance sheet?

Second, what are the company's obligations at the reporting date that arose from past activities and must be settled by relinquishing assets or providing services? That is, what liabilities does it have at the reporting date, including those that can and cannot be measured reliably enough to be recognized on the balance sheet?

A key point here is a company's financial position at a reporting date depends on all assets and liabilities, including those that are not recognized, and there're going to be plenty of them.

Nevertheless, investors and other users tend to focus on metrics based on recognized assets and liabilities, which leads to our third question. What resources and obligations are recognized on the balance sheet as assets and liabilities?

Fourth, how reliably are they measured? Depending on the business context, which assets and liabilities should be recognized and how they should be measured, well, that can require considerable judgment by insider-preparers. To the extent these judgments exist, assessing the usefulness of reported numbers will be more challenging for outsider-users.

Fifth, how might stakeholders' assessments of the company's financial position and related risks affect their decisions?

While these questions are quite similar to those we posed earlier about your financial position, answering them is considerably more challenging for companies, especially large companies.

Next, we'll close this video with three key take-aways.

First, companies use accounting systems to record, aggregate and report numerous measures of economic activities.

To put this in perspective, consider the challenges we, and perhaps you, might confront creating our balance sheet versus those a large global company like General Electric, Siemens, or Walmart confronts.

We could probably list most of our personal assets and liabilities on a few pieces of paper and create a pretty reliable balance sheet by referencing a relatively small box of related receipts and bills outstanding. In particular, we wouldn’t need to have recorded our assets into an accounting system as we acquired them, nor our liabilities into a system as we incurred them. We’d just look at the box of receipts and bills.

This won’t work for a large global company, which can have billions of activities in hundreds of currencies. In fact, it won’t work for all but the smallest of companies.

After accountants judge whether and where measures related to these activities should be recognized in the balance sheet and how they should be measured, the resulting measures are recorded into accounting systems where they are aggregated and stored until they are reported in balance sheets.

Now, consider the scope of this transformation. The net effects of billions of past transactions are summarized on a single page. The complexity of this process and significant number of judgments, leads to our second take-away.

A balance sheet is a fuzzy, but useful, picture of a company’s financial health at a reporting date, but it’s only useful if it’s properly interpreted. Balance sheets are often referred to as pictures of companies’ financial positions or financial health at a reporting date. But they’re not usually described as fuzzy pictures.

This is another situation where the public perception differs from reality. If you were to describe a balance sheet as pictures to someone who had not taken an accounting course, well, they’d likely think you meant a photograph. However, the reality is balance sheets are more like x-rays, or MRIs, or some other medical image. For instance, like medical images, a good deal of information is missing or measured with varying degrees of imprecision.

Also like medical images that must be interpreted in the broader context of the patient’s medical history, well, balance sheets must be interpreted in their broader context of the company’s business and industry. Still, just as medical images help doctors make informed judgments about patients’ health, balance sheets, while imperfect, help insiders and outsiders make more informed assessments of a company’s financial condition.

Our third take-away further underscores balance sheets importance. Assets and liabilities have conceptual primacy over the elements in the other primary financial statements. This means the definitions and measures of the elements in the other statements are based on changes in asset and liability measures. Watch for this as we preview Income Statements in Part 2 [of this video series], Cash Flow Statements in Part 3, and Statements of Changes in Owners’ Equity, also called Statements of Owners’ Equity, in Part 4.

Hope you’ve enjoyed this video.
See you in the next one.