## Video Transcript

## Introduction to Financial Statements Part 2: Income Statements

### Topics

- Part 2 of a 4-part series that introduces the primary financial statements companies report to their stakeholders.
- Introduces the purpose, structure, and uses of income statements.

## Transcript

Welcome to Part 2 of the 4-part series that introduces the primary financial statements. Here our focus is on income statements, which measure performance over reporting periods, such as one year, a quarter, or half of a year.

We begin with four questions:
- What does it mean for a company to perform for its owners? That is, what economic activities do income statements measure?
- How is this performance measured on income statements?
- Which user decisions might be affected by income statement information?
- What determines the usefulness of this information for users' decisions?

So, let's address the first question:

Performance measures progress towards a goal. So, to understand what it means for a company to perform for its owners you need to know the goal the company's management team is pursuing on behalf of its owners.

For the for-profit companies we will be studying, management's goal for a reporting period is to maximize the return shareholders get on their investment over this period. More precisely, the goal is to maximize this return relative to other investment alternatives with comparable risk, while all along complying with laws and social norms. Importantly, this does not preclude taking care of other stakeholders and, more generally, serving the public interest.

We'll use a simple example to develop what is meant by return on investment. Then we'll explain how this return relates to measures reported on income statements.

Suppose you started a company on the first day of the year. The company's balance sheet equation at this point would be: Assets = Liabilities + Owners' Equity. But there wouldn't be any assets. No liabilities. No owners' equity. Because you just started the company.

We'll assume that immediately thereafter, the company issues $100 thousand of common stock to you and other shareholders in exchange for cash. So, right here. Because the company received cash, its assets increased to $100 and because it issued shares, which are ownership claims, owners' equity also increased $100.

So our equation right here becomes: Assets = Liabilities + Owners' Equity. So we now have $100 of assets, $0 in liabilities, and $100 of owner's equity.

Now suppose that at the end of the year, way out here, a reliable expert estimates the shares could be sold for $110, if the owners chose to do so. The expert tells you the value of the shares increased from $100 to $110 because the company performed well during the year and this performance is indicative of future performance.

So our balance sheet equation at the end of the year, since we have no liabilities, by assumption, will be Assets = Liabilities + Owner's Equity. Assets are now $110. We're going to assume no liabilities. So, owners' equity is $110.

Next, we'll define the owners' return on their investment over the first year. That is, over this reporting period, right here.

The owners' return depends on the change in owners' equity during the period. To get a better understanding of this change we first create a new equation that reflects the change in the balance sheet equation during the period. So the assets changed from $0 to $110. So, we'll call that change in assets, where delta ($\Delta$) represents change, equals change in liabilities plus change in owner's equity. Now the assets changed. It went from $0 to $110. So, that's $110. Liabilities didn't change at all. And the owners' equity changed by $110.

Moving the change in the liabilities over to the asset side of the balance sheet (equation) changes its sign. So now, we are focusing solely on owners' equity changes, which is what we want to be focusing on, because this is our primary interest.

Next, we split this change into two parts: Transactions with owners and return on owners' investment. So, transactions with owners and return on owners' investment.

Transactions with owners measures the change in their investment in the company during the period. For our example, we'll assume there is only one transaction with owners during the period, namely issuing the $100 of stock. So, we've got $100 of transactions with owners. Well, then mathematically, if we started out with $110 of change (in owner's equity), we've got $100 of transactions with owners, and we've got $10 return on owners' investment. But, what does this represent?

This is the amount the owners' would receive in excess of the $100 they invested, if they sold their shares for $110 at the end of the year.

So management's goal is to maximize this return.

Next, we'll explain what management does to work towards this goal.

Management pursues the goal by managing the economic activities associated the company's assets and liabilities, including those not recognized on the balance sheet. For example, by buying merchandise, which are assets, to resell to customers.

Management performs, that is makes progress towards this goal, to the extent these activities increase owners' equity, and in particular, the return on the owners' investment. For example, management performs to the degree the company sells the merchandise for more than it cost to acquire, store, sell, and deliver (the merchandise).

Importantly, the return on owners' investment is outsiders' assessment of this performance, conditional on what they know at the time.

In our example, the outsider is a reliable expert, that's where the $110 came from. But for publicly traded shares, it's the stock market. This means the performance goal has two key dimensions. To maximize owners' return, management must: first, manage economic activities towards this end and second, communicate this performance credibly and faithfully through income statements and other supplementary disclosures.

This means the equations related to this performance goal that we have been studying, they must include all of the company's assets and liabilities, and these must be measured at current values. By current values, we mean, more precisely, the values that would be received by putting assets to their very best use, between keeping or selling them, for example, and the values that would be surrendered by settling liabilities at their lowest cost.

Next, we address the second question we posed earlier: How is performance for owners measured on income statements?

Comprehensive income is the broadest performance measure reported on income statements, meaning it measures the broadest scope of economic activity. It's defined similarly to the return on owners' investment in that it is the change in owners' equity during the reporting period, excluding transactions with owners.

But, the assets and liabilities that determine owners' equity, and thus comprehensive income, are measured at book values, meaning those reported on balance sheets, which are generally a mixture of current values and historical costs. And assets and liabilities that can't be measured reliably, well, they're excluded. To emphasize this difference, we'll assume the book value of the recognized assets and owners' equity for our example at the end of the first year is now $109, rather than the $110 we had earlier.

The book value of owners' equity, well, it can change in a few other ways over here. So we actually have another tributary over here. But these are so infrequent, and they're generally very small, and they're way, way beyond the scope of this course.

Next, we briefly discuss income statements' primary elements. What do you see when you look at an income statement?

The first thing to notice is that comprehensive income is the last line on the income statement.

Comprehensive income has two components: Net income and OCI which is also called Other Comprehensive Income. Our focus in this course will be almost exclusively on net income.

OCI measures economic activities that are beyond the scope of the course. Still, it has one feature we want you to understand: OCI is transient. Meaning it's highly unlikely OCI reported this period will occur again next period. As a result, it's not very useful for predicting future performance.

Net income, which is also called earnings, is focused on extensively by the media, investors, and management. You're going to see it everywhere; in newspapers, on the radio, on TV. We will be spending a good deal of time in the course studying net income.

We'll also see that companies can split the income statement, shown here, into two parts reported on consecutive pages, with the first part focusing solely on net income and its components, which we'll study next.

Net income has four primary elements: Revenues, expenses, gains, and losses. We will study these in great detail in later modules. For now, you only need to know two things:

First, all of these elements are defined as increases or decreases in owners' equity. Owner's equity changes go to comprehensive income goes to net income goes to each of these components.

Thus, income statement concepts and measures are based on balance sheet concepts and measures.

Second, some income elements are more useful for predicting future performance than others. For example, similar to OCI, gains and losses are transient and therefore not very useful for predicting future performance.

Next, we'll briefly address the third question we posed at the start of the video: Which user decisions might be affected by income statement information?

At the big-picture level, income statements are used in various contexts to either assess past performance or predict future performance. For example, company insiders assess past performance using income statement information when deciding whether employees should receive bonuses based on meeting performance targets that are based on income.

Outsiders primarily use income statement information to predict future performance.
For example, investors, when deciding whether to buy or sell the company's stock.

Next, we address the final question we posed at the start of the video: What determines the usefulness of income statement information for users' decisions?

We've already discussed the two factors that largely determine the usefulness of income statement information.

First, income statement information is useful to the extent it helps predict future performance. For example, transient items such as OCI and gains and losses, well, they're not useful at all for predicting future performance.

Second, income statement information is useful to the extent it faithfully reflects the underlying economic activity. In particular, when assets or liabilities are not recognized on balance sheets because they can't be measured reliably enough to faithfully reflect the underlying economic activity, changes in their values during the period, well, they don't affect the income statement, which diminishes its usefulness. This shortcoming is particularly problematic for high tech companies whose success depends greatly on their capacity to invent, develop, and market new products.

Generally, US accounting standards don't allow these companies to record assets as products are transformed over time from ideas to sales, even though significant future benefits are created and therefore the company is performing exceptionally well.

The usefulness of income statement information can also be diminished or enhanced when considerable judgment is required to measure assets and liabilities recognized on balance sheets, whose changes will ultimately affect income statements.

The key point here is when valuable information about performance is not included in income or measured with considerable judgment, well then, companies tend to disclose supplementary information to help users make more informed performance assessments.

Next, we close this video by revisiting the four questions posed earlier.

What does it mean for a company to perform for its owners? We've seen that management's performance goal each period is to manage the company's economic activities in ways that seek to maximize the owners' return on their investment.

How is this performance measured on income statements? You should now understand that the broadest performance measure is comprehensive income, which is the change in the book value of owners' equity, excluding transactions with owners.

Which user decisions might be affected by income statement information? Throughout the course we will see that insiders and outsiders can use this information to assess past performance and predict future performance.

What determines the usefulness of income statement information for users' decisions? At the big picture level, we've seen that income statement measures are useful to the extent they faithfully reflect the underlying economic activity and help predict future performance.

We'll dig much deeper into all of these issues in later modules.

In the meantime, hope you enjoyed this video.
See you in the next one.