

Video Transcript

Introduction to Financial Statements Part 4: Statements of Changes in Owners' Equity

Topics

- Part 4 of a 4-part series that introduces the primary financial statements companies report to their stakeholders.
- Introduces the purpose, structures, and uses of statements of changes in owners' equity.

Transcript

Welcome to Part 4 of the series that introduces the primary financial statements. Here our focus is on the statement of changes in owners' equity, also called the statement of owners' equity.

The purpose of this statement is to explain the reasons owners' equity changed during a reporting period.

Most of the information reported on statements of changes in owners' equity, well, it's also reported on balance sheets, income statements, or cash flow statements. As a result, we've already seen how most of the information on the statement affects users' decisions; is useful for these decisions; and is affected by economic activities. There are a few situations where information not reported in other statements is reported on statements of changes in owners' equity, but these mostly center on topics that are far beyond the scope of the course.

We begin with a question that centers on an accounting judgment: How are statements of changes of in owners' equity structured? What should you expect to see when you look at one? Companies generally choose between two formats that are structured differently, but provide the same information.

We'll develop one of these relatively slowly and then quickly explain how it differs from the other.

Let's get started.



First, let's take a closer look at the owners' equity section of balance sheets. Up until now, we've essentially collapsed the balance sheet into three items: assets, liabilities and owners' equity. And while we didn't explicitly say so, the balance sheet equation was $\text{Total Assets} = \text{Total Liabilities} + \text{Total Owners' Equity}$.

Yet, balance sheets present numerous line items. For example, in this video, we'll assume the example company reports three line items in owners' equity: Paid-in capital; Retained earnings; and Accumulated OCI, or accumulated other comprehensive income.

Because this is the first time we've mentioned line items, rather than primary elements, we want to emphasize they have two characteristics: the phrases that describe them are called "captions", and the amounts reported are the second characteristic.

We'll define these three line items as we develop the statement of changes in owners' equity. For now, you only need to understand three things:

- First, as indicated in the expanded equation down here, the amounts reported for the three line items, well, they sum to total owners' equity.
- Second, most companies report these line items, although some use synonyms for the same concepts.
- Third, many companies, especially larger ones, report other line items representing different concepts than those that are presented in these three examples. We'll study these in later modules.

Next, we'll develop one of the two formats used for this statement. In particular, the one you will likely encounter most during your career.

Keeping in mind that the statement explains the change in owners' equity reported on the beginning and ending balance sheets, we begin by describing these balances and leaving enough space between them to explain the changes.

The first thing to notice is the statement is a table, whose top row is the beginning balances and the bottom row is the ending balances and explains the change in the line items on the balance sheet.

From the earlier videos, we know the change in owners' equity during the period has two components: Transactions with owners and Comprehensive income. Recall, other items that are infrequent, relatively small, and beyond the scope of this course, well, they can also

change owners' equity. So, we really should have a third category over here, but we're going to skip that. It's beyond this course.

We also know from earlier videos that comprehensive income has two components: Net income and OCI, that is, other comprehensive income. We'll give an example shortly to explain the gray boxes up here. But first, we'll take a closer look at transactions with owners.

Transactions with owners has two parts: contributions from owners, such as cash the company receives when it issues common stock, and distributions to owners, such as the cash the company distributes when it declares and pays dividends. Next, we'll use an example to explain the balance sheet line items and the gray boxes.

This example extends the one we developed in Part 2 of this series to explain income statements. At that time, we focused on balance sheet changes during the first year a company was in business. Here we will extend the example to the second year and our goal is to create a statement of changes of owners' equity for the second year. So, this will be the second year statement of changes in owners' equity.

Accordingly, the top row of the statement is amounts reported on the balance sheet at the end of the first year, and thus, at the start of the second year. We could have started with a first-year statement, but to save time we'll go directly to the second-year, which is more informative.

Recall from the earlier video, that during the first year:

- Owners' equity increased \$109. This had two parts: transactions with owners was \$100 and comprehensive income was \$9.
- Now, transactions with owners had two parts also: contributions of \$100 and there were no distributions.
- Comprehensive income had two parts: net income was \$9 and OCI was \$0.

So the first year was really quite simple.

Next, we'll explain how these numbers down here, map into the balance sheet line items in our statement:

- Paid-in capital reports cumulative past contributions from owners, net of distributions, where these distributions to owners return previous contributions by them. This occurs

when companies buy back previously issued shares from owners. Thus, for these distributions the company gives the owners cash in exchange for shares. These share buy backs differ from dividends, where the company also distributes cash to owners, but there is no exchange. They get nothing back. Because there were no distributions during the first period and, in particular, no share buy backs, the paid-in capital balance at the end of the first year is \$100. The only thing that happened, of course, was that the company issued shares for \$100.

- Retained earnings is the cumulative earnings, that is the cumulative net income, prior to the balance sheet date, less the cumulative distributions of earnings prior to this date. Wow, that's a mouthful! Don't worry; the year-2 analysis presented shortly, well, it'll help you exactly understand what we mean here. What you need to know now is that at the end of year 1, there's \$9 of retained earnings. Why \$9? Because there was \$9 of first-year income and there were no distributions.
- As its name suggests, Accumulated OCI is the cumulative OCI prior to the balance sheet date, which is \$0 at the end of the first year because there was no OCI.
- The "total" line item reports the total owners' equity, \$109 at the end of the first year, which is also the sum of the other three columns.

Next, we turn to the second year numbers.

We'll assume that during the second year:

- Owners' equity increased by \$28
- Transactions with owners was \$15
- Comprehensive income was \$13

The two parts of transactions with owners was contributions of \$20 and this time we'll have a distribution of \$5.

And net income was \$11 and this time we'll have OCI of \$2. So, that adds up to the comprehensive income of \$13.

Now let's see how these numbers affect the second-year statement of changes.

We'll start with the net income row up here. Notice there's \$11 increase in retained earnings and \$11 increase in total equity. Where did that come from? Well, we had \$11 of net income. So, the \$11 of net income goes into retained earnings.

Thus, by the end of the second year a total of \$20 of earnings had accumulated in retained earnings during years, \$9 + \$11.

- Similarly, the \$2 of second-year OCI increases Accumulated OCI. So, here's the OCI line item and we've got \$2 going into Accumulated OCI.
- And, similarly, we had \$20 worth of contribution from shareholders and that \$20 is going to go into paid-in capital.
- Because we're assuming the \$5 year-2 distribution was a dividend, it decreases retained earnings. Thus, the \$15 retained earnings balance at the end of year 2 is the \$20 cumulated up here in earnings, less the \$5 of cumulative dividends, which is just the dividend of the second year.

Dividends are the most common distribution of earnings, but later in the course you'll learn about a few others.

Before moving on, here is a small caveat regarding dividend distributions. While it's acceptable to say "dividends distribute earnings to owners", a more precise way to say it is "dividends distribute cash to owners", which decreases assets and thus the value of the owners' claim on these assets, and, more specifically, decreases retained earnings.

At the start of the video, we said most of the information reported on statements of changes in owners' equity, well, it's also reported on the other statements. We can now illustrate what we meant:

- The balance sheet reports information on the top and bottom rows. So, all these numbers up here, you'd find on a balance sheet. Down here too.
- The income statement reports net income and OCI. So, this information would be on an income statement. Balance sheet. Balance sheet. Income statement.
- And for our example, the cash flow statement would report all this information here, which are the transactions with owners. So, the statement of cash flow would report that.

So, for our example, we learn nothing new from this statement that we couldn't have learned from the other three statements. Still, this may not be true for real companies. Sometimes two line items that are reported separately on the statement of changes in owners' equity, well, they're combined on the statement of cash flows. So, you'd learn something by going to the statement of owners' equity. The opposite can also be true.

We'll see examples of both of these situations in later modules.

Next, we'll close this video by briefly comparing this format for the statement to another one you'll likely encounter, albeit less frequently.

As indicated earlier, the information in the two formats is identical. The difference is the balance sheet line items are now rows rather than columns. So, if we look over here we see the rows where over here we had columns.

And the balances and changes are grouped together for each balance sheet line item. So, we've got these little categories. See these little groups right here? You go down and you get the ending balance for the first year, which is the beginning balance for the second year, and you get the items that changed it. And you eventually get the ending balance. So, everything is consolidated into these small groups.

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