

## Video Transcript

### Introduction to Financial Accounting: Closing Thoughts

#### Topics

- How are the primary financial statements connected?
- How are we going to deal with complexity?

#### Transcript

Welcome to the final video in the Introduction module. Here we will share a few closing thoughts by addressing two questions: How are the four primary financial statements connected? And, how are we going to deal with complexity? Real financial statements and related analyses can get pretty complicated and we want to ensure you have a strategy to tackle this complexity.

We begin by reviewing concepts needed to address the first question.

We call the concept map here that developed in earlier videos the “Owners’ Equity Change Map”, or OEC Map for short. We’ll be developing other concept maps during the course and demonstrating how they connect to each other and to the Pathways Vision Model.

Concept maps are robust or powerful to the extent they explain a wide range of phenomena. By this measure, the OEC Map is tremendously powerful. You’ll soon see how a slightly modified version of the map includes the primary elements of all of the financial statements and explains how the statements are connected. The OEC Map is also foundational for recording accounting information, something we will be doing every module.

Next, we modify the map slightly for our purposes here by including information related to cash flow statements.

We split the change in assets into changes in cash and changes in other assets, and then we split the change in cash into operating, investing, and financing cash flows.



Next, we're going to use this map to explain how the four financial statements are connected to each other.

We begin with the balance sheet, which is based directly on the balance sheet equation, that is, on the BSE, balance sheet equation. The map underscores the balance sheet's conceptual primacy; the primary elements of the three other statements are all defined in terms of balance sheet changes.

All of the income statements' primary elements are defined in terms of changes in owners' equity, which is the same as the change in assets minus the change in liabilities, which is called the change in "net assets," meaning assets minus liabilities. Thus, the only way an income statement primary element can change is if net assets change. The income items are over here. Net assets are over here. And there's an equal sign in between. So the only way you get a change on the income statement is if you get a change in net assets. And if net assets change over on this side of the equation and there's no transaction with owners, well then, income must change.

Because of the BSE, the only way cash can change is if one or more items in the equation also change. So here's cash. So one of these other items in the equation, well, they must change. For example, if a company purchases a building with cash, investing cash flows decrease and other assets increase. Similarly, if the company issues debt, financing cash flows increase and as do liabilities, but they're on this side of the balance sheet in the net asset form of the balance sheet equation. So, there's no change over here in owners' equity.

And we know, from the previous video, that the statement of changes in owners' equity, well, it fits directly into the map.

When we started the video series on financial statements, we told you every term and concept in the series would be explained and developed in greater detail in later modules, so you should relax and focus on the big picture.

Here is one big picture we hope you will take away. Not the details, you will learn these later. Rather, the key lesson here is that the four financial statements and many related concepts, well, they're all based on the BSE, and, more specifically, on the definitions of assets and liabilities and on their measures. This is the reason we'll start digging deeply into balance sheets in the next module.

Next, we will address the second question we posed at the start of the video: How are we going to deal with all of this complexity?

Your success in this course, that is the extent to which you meet the goals discussed in an earlier video, will depend greatly on your capacity to deal with complexity. In this regard, there are two success factors: First, you need to internalize concepts, meaning make them part of the way you understand things, rather than something you memorize to regurgitate on tests. Second, you need to apply concepts repeatedly in diverse contexts.

For example, this picture explains the highest level concept related to balance sheets: the BSE. In the next module we'll introduce lower level concepts for the balance sheet.

Here is an application of these concepts: Intel's balance sheets at the end of 2013 and 2012.

Now you know what we meant earlier when we indicated real financial statements can be rather daunting, especially when you first encounter them. Look at all those numbers! True, but the OEC Map on the left will help you start to cut through this complexity.

For example, we know every line item on Intel's balance sheet is either an asset, a liability, or owners' equity. And, in particular, each of the 13 assets up here are future benefits Intel controls that arose from past activities.

This is the concept: the definition of an asset. It's applied differently for the 13 assets and, in particular, is applied to different economic activities. The future benefits are qualitatively different.

You can get a pretty good grasp of concepts by watching videos or reading text books. And you can even get a good start on applications. But the only way to become proficient at applications is to tackle them on your own, in as many contexts as possible, until you eventually get to where you can discern the subtle nuances that characterize different contexts. This is the key to success.

This is the reason we are going to expose you to numerous companies' financial statements during the course. You will likely struggle with this challenge early in the course, most students do, similar to the way you would struggle if you were to immerse yourself in a foreign country to learn the language and culture.

The bottom line here is applications are inherently complex. By contrast, concepts abstract from complexity and they're characterized by simplicity. This doesn't mean they're easy to learn, but rather, once learned, they simplify complexity.

The concepts shown here center on accounting issues only. From the Pathways Vision Model, we know you will need to learn and apply many more concepts to prepare or use financial statements effectively. And, in particular, you'll need to understand concepts related to the underlying economic activity; users' decisions; assessing the usefulness of information for these decisions; and their consequences on economic activity and accounting judgments.

When we introduced the Vision Model in an earlier video, we told you it was simple, yet deep, meaning it explains a wide range of phenomena. You likely already have an appreciation for the Model's concepts, but we've only begun to drill down into its depths.

We're going to close this Introduction module with a famous quote by a former US Supreme Court Justice, Oliver Wendell Holmes.

“I wouldn't give a fig for the simplicity this side of complexity, but I'd give my life for simplicity on the far side of complexity.”

What did Justice Holmes mean by simplicity on “this side” versus “the far side” of complexity, and what does all this have to do with the course?

It's generally believed that Holmes was distinguishing simple but shallow, meaning not capturing reality, which he clearly despised, from simple yet deep, meaning faithfully capturing reality, which he clearly revered.

An application of this quote is the Pathway Commission's Model for the public perception of accounting versus the Commission's Model for the reality of accounting.

This course would be much, much easier if we based it on a model closer to the public perception, but it would be on the wrong side of complexity.

To get to the far side of complexity is more challenging, but far, far more rewarding. In particular, it means you will need to internalize concepts and repeatedly tackle application exercises on your own.

Importantly, accounting is not a spectator sport; you must get into the game. You've got to start playing the game. Watching us, your professor, or your classmates do exercises occasionally is ok. But failing to struggle through problems on your own, that's a recipe for disaster.

In this regard, starting next module, it will be time to ignore our earlier advice when we told you to put aside your pen and paper, relax, and focus on the big picture. Not any longer! No. Now it's time to get out your pen and paper and start tackling the exercises.

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