

Express Video Transcript

Framing Record Keeping and Reporting

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Transcript

We've already seen that we can learn a great deal just from what's on the surface of a balance sheet and in the footnotes, but oh, there's so much more to learn if you just understand what's behind the numbers. In this video, we're going to begin to build a framework for understanding what's behind the numbers.

We're first going to start by reviewing that top-down perspective we looked at earlier and then extending it into what's behind the numbers. And along the way, we're going to introduce the balance sheet equation matrix. This is the workhorse for the framework of what's going on behind the numbers, and it also connects what's going on behind the numbers to what's happening from the outsider perspective. And that's part of the R&R Map, which we'll introduce in this section. This is students' favorite tool for learning accounting. We're constantly being told how much they use it, so we're now going to introduce it. And I think you're going to find it remarkably useful as you go through your studies of accounting.

Top-down perspective:

We begin with a little review. What does an outsider see? They start with the primary elements, looking at total assets, total liabilities, and total owners' equity. And that allows them to get a sense of the overall financial leverage, and that is, the extent to which the assets are financed by liabilities versus owners' equity, and the extent to which the assets will cover the liabilities. But then we said, well, you have to worry about timing, and so we looked at the current assets and the current liabilities and that got us to the concepts of working capital and current ratios. From there, we said, well, even if the timing looks good, that's all based on what we expect to happen; but what we expect to happen can turn out to be quite different from what really happens. So we looked at the line items and from the line items we got to assess their risk and that gave us a better sense of whether their realizations would occur. As we did that, we got a real good understanding of what's going on, on the surface of the statements. Now, we want to go one step further. What's behind the line items?

Accounts

Behind the captions on the line items, like accounts payable, are accounts. Accounts are just reservoirs for storing information. So we collect data and we store it in accounts. Also on the face of the statement, we have the numbers that go with the line items. Well, what's behind the numbers are the account balances. So each account will end up with a balance at the end of the year and those balances go on to the balance sheet.

Events

Behind the account balances are events and measures. Now, here we've got an explanation of what the account looks like. It begins with a beginning balance, so that was \$35 million for accounts payable, and it ends with \$25 million, which of course is on the balance sheet.

Measures

In between, we record measures by recording events. And so measures go into the account and measures correspond to events. Now we had two events that happened here that we're going to be focusing on in this chapter. First of all event E4, "E" for event, event E4 for Bischoff, was that Bischoff bought some merchandise, that it was going to resell to customers, on account and that meant it owed the suppliers \$80 million. Now, Bischoff also paid off \$225 million that it owed for prior purchases on account. Now, there are some other events that we'll be studying in subsequent chapters that happen during the period. We started with a beginning balance, we add in the net effect of all of these entries, and we ended up with \$25 million that went back on our balance sheet.

So, when we see a number on the balance sheet, we'll know that's the ending balance for an account. It's tied to the beginning balance, which is also on the balance sheet. It's in the next column over. So, if you want to understand why the balance sheet changed, you need to understand the measures. But to understand the measures, you need to understand the events; because the event is what was going on in the business. So, these are the numbers that connect to what was going on in the business. But what's behind the measures?

Entries

Entries are behind the measures in accounts. We'll be looking at entries in the next module in great detail, but what's behind the entries?

Judgments

Behind the entries are recognition and measurement decisions. We first decide, are we going to recognize an entry, and if so, is that going to be recognized on the balance sheet? Well, those decisions require significant judgment.

Now we can put it all together. If you're an outsider, you start by looking at the balance sheet. You start with the primary elements, then you look at the major categories, then you look at the line items, and that's all you really get to see. But what's behind the numbers? Well, first are accounts, then there're entries, which record measures for different events, and then judgments, which determine what gets measured and how much is measured, and then there're classification and disclosure decisions. So that's the entire chain starting from the top. And when you understand all these steps, well, then you have a really solid understanding of what's behind the numbers you're looking at.

Balance-sheet equation matrix:

Now, here's the workhorse that we're going to be using over and over to store data. And it's a representation of how data is stored by real companies. Real companies actually store data as bits and bytes in computers. But this representation is powerful and it's going to help you understand what's going on.

So what do we have so far? Well, we've already looked at accounts payable, we looked at one column. And here's its beginning balance and we saw it had an ending balance, we saw it had a bunch of events that happened. So, we were looking at the events for accounts payable in our earlier discussion. Now, what we're going to do is go one step further. There's a bunch of accounts and this matrix is going to store them. And then we're going to be able to use this matrix to find out how data is stored and how it's transferred into the financial statements. It's a powerful tool, but it does look rather busy right now. So let's break it down into its component parts.

Header

The first balance sheet equation matrix element is in the header: the primary elements. Here we have the balance sheet equation, $\text{assets} = \text{liabilities} + \text{owners' equity}$. That's why it's called the BSE matrix. Everything centers on the balance sheet equation. Then underneath that we have the major categories; current and non-current assets, current and non-current liabilities, and permanent owners' equity. We'll be adding temporary owners' equity over here in the next chapter.

Columns

For the columns we want you to notice are three things at this point. First, for every account there's a column; cash, accounts receivable, inventory, and so on. Then there are account

signs. For every account there's a column of signs right in front of it. We're going to describe those account signs when you learn how to record entries in the next module.

There's also an equals sign and that's fundamentally important because this is, after all, the balance sheet equation matrix. The entire matrix is tied together by a series of equations. Every row gives you an equation.

Rows

Well, let's look at the rows. We've already seen that the top row is the beginning balance, the bottom row is the ending balance, and everything in between are the entries. So this part of the matrix is all recording entries.

Cells

In each cell, you'll notice there are two things; one is the measure, here 225, and then there's the entry sign. And the entry sign, like the account sign, will be discussed when we learn how to record entries. For now, just notice there are two signs in front of every number: the account sign and the entry sign.

Record keeping and reporting map:

This is what's called the Record-Keeping and Reporting Map or the R&R Map. Right away we say, well, if you had the balance sheet equation all filled out, that is, if you knew what all the data was, you could make a balance sheet really fast. How do you do that? You take the numbers off the top row, and that becomes the beginning balance, and then numbers off the bottom row, that becomes the ending balance.

Insider perspective

There are two ways to look at this from the insider's perspective or the outsider's perspective. Now, the insider starts at the top by building the matrix and then eventually ends up with the statements. Here are the steps: They first observe the events, "Something is happening in my business." Then they make a recognition decision, "Should I recognize this on the balance sheet as an asset," for example. Then they make a measurement decision, "Well, just how much asset should I recognize?" Then they record an entry, which connects that asset to other aspects of the balance sheet equation and makes everything balance up nice in the accounts. Then they determine the ending balances by adding up the beginning balance and all the entries that happen in each account. Then they make disclosure decisions.

Now, what we mean here, and this is important, is there's only about 15 or 20 line items on most companies' balance sheets and yet most companies will have thousands of accounts. So, they've got to combine the account balances into each line item. And that's done by deciding what gets disclosed. What does the reader actually get to see? Well, that determines how they aggregate the information up above.

Now as we start Bischoff, there's one line item in Bischoff on the balance sheet for every account, but there's going to be about 80 accounts in Bischoff by the time we get finished.

Outsider perspective

Now, the outsider looks at things just the opposite. Remember, an outsider starts out and all they get to see is the balance sheet. They have to try to figure out what's going on up above the balance sheet. They get to observe, actually see on the face of the balance sheet, the primary elements and then the major categories, and then the line items. Now, they have to start envisioning, that is, in their mind's eye, they have to see the accounts behind the line items. And then they have to envision the structure of the entries that went in to those accounts, not necessarily the numbers, but just envision the structure. What was it that went in? And then they have to identify other line items that are affected by those entries and footnotes and that can help them find information. And then they have to qualitatively gauge the measures, just how big was that number? Was it large or was it small? How much effect did that entry have on this account that I'm looking at because maybe I can qualitatively get a sense of what it is that I'm analyzing. When possible, they can actually recreate the entries because they found other information in the footnotes, or wherever, and that gives them a much deeper insight of what's going on behind the numbers. And then, the last step is they can envision the measurement and recognition judgments behind the numbers and then assess how much confidence they should have in them.

It would be wonderful if you could put the same level of confidence in every number on the balance sheet. You could say, "Well, this thing is measured really accurately and I trust this number." But if that was true there'd be no Enrons, no WorldComs [scandals], and even if everyone was honest, all the numbers aren't measured as reliably. Some are measured very, very accurately and very reliably and others are just very noisy. That's what we mean when we say a balance sheet is fuzzy. Well, you need to understand those judgments so when you're looking at one number, you'd say, "Well, I don't really trust that number. This one I'm not quite as confident in. I'll use it, but when I draw conclusions, I won't have quite as much confidence." You can't do that without going behind the numbers.

Take-aways

What should you know by now? Well, you've got to learn all these elements for the matrix. I know it looks busy right now, but it's going to become second nature to you. Work your way through it one element at a time. Make sure you understand them.

You need to understand the power of how we're going to use this when we're looking at the R&R Map. This is just the start of the R&R Map. What does the insider do? How do they use this map? How does the outsider use the map to navigate the financial statements and work their way back into the business?

The map can be extended and that's where we're heading. This is the power of the R&R Map and you'll find this R&R Map right over near the glossary on the right. You're probably looking at it now and saying, "Wow, I thought the earlier one was busy. This one is insane." And you're right. It's really, really busy now. So, what's going to happen is you could actually penetrate this map, look at any details you want, and then you can zoom out and get a bigger picture perspective. And we're going to see how that works throughout the book. So, let's get started right now with just a little, brief introduction.

We're going to do that by looking at a PDF of the R&R Map. So here's a PDF of the R&R Map and I'm going to show you how you can navigate it. So you can go up here, pick up the

magnifying glass, and go down and begin to think about, well, I'd like to get a better idea of what some of the things are that are going on here. Well, let's look at something that we already know. Let's look at some of those entries that are early on in the matrix. There they are: purchase merchandise for resale, paid invoices due, event E4 and E5. Now we can zoom back out.

We can say, "Well, what about the balance sheet? I'd like to look at the balance sheet." Well, there it is. Let's just look at the top part of it. And you can get as much detail as you want. So you could say, "Well, I can't see that." There you go. If you can't see that, zoom right in. It's perfectly zoomable. You can go to any level you want and you'll see all the details. And that means you can trace things all the way through the matrix and you can do that over and over.

Now, one of the things that's neat about this is if you're an outsider, this is what you're going to see down here. These are all the financial statements. Here's the balance sheet, here's the income statement, another chapter, here's the statement of shareholders' equity, here's the cash flow statements, direct and indirect. Now, all of those are going to make sense to you later. And as you learn about them, here's what's neat. You'll be looking at them as an outsider, looking through the annual reports, and you'll be seeing what's behind them and it's all up here. It's all up here and it's perfectly organized. This matrix is a little different than the one we're looking at right now, but not much. And we'll be introducing those differences over a couple of chapters and then it'll be old school to you.

And the other thing that's neat about this is you can see how all the statements connect to each other. So when you're working inside a company, and you may not be an accountant, but something is happening in your company, like a business event is going down. Well, you can say, "How's that event going to affect all my financial statements and therefore the metrics on which I'm being measured for my performance reviews?" Well, you'll understand that. You will understand how every entry up here flows into every statement and therefore into every ratio and in every metric.

Well, that's a brief introduction, but I hope you're starting to get excited about the R&R Map. Students love this map once they get used to it. It does take awhile, but believe me it's going to become second nature to you and we're going to use it over and over.

Hope you enjoyed the video. Look forward to the next one.