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FINANCIAL REPORTING | BASIC

Video Transcription: Financial Statements – The Big Picture

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Hi, I'm Jimmy and in this video I want to show you the full financial statements from a big-picture point of view. This is because once you see the big picture, the details will all start to make sense. To help you see this big picture I want to focus on two questions – what do the financial statements tell us, and how are they all linked together? Now the conceptual framework gives us a pretty quick answer to that question. It says financial statements are there to show financial position and financial performance. But let's think for a moment what that really means. What do position and performance mean, generally?

Look at this picture of a dancer in a certain position, here she is in another quite different position. Her performance involves various movements, which bring her from one position to the next, which we see in this video clip.

Now I can get pretty excited about accounting but even I have to admit that people, unlike when they look at a dancer, are not looking at financial statements for an experience of beauty. The financial statements are there for existing and potential investors and creditors to use in their decision-making. Primarily, they want to access the financial performance of the business in the future so that they can decide, if they have lent the money, whether the business will be able to repay it or, if they have invested it, whether the business will pay them a return on that investment. To access the future financial performance,they look at the current financial position, which can tell quite a lot just as the picture of the dancer can show that she has strength, poise and grace. One can definitely use this information to tell how good a dancer she is. But of course it would be even more helpful to see her performance, the movements that have brought her to this position.

So, the financial statements consist of a Statement of Financial Position, which is like a snapshot of the business at the end of the reporting period and a snapshot at the beginning of the reported period. Then, there are three other financial statements, which show financial performance. In other words, they show the movements from one snapshot to the next. That is why we are so careful to write 'as at' the reporting date on a Statement of Financial Position and why we write 'for the year ending' on the other three financial statements.

Let's look at what the Statement of Financial Position tells users. Unlike a single dancer in one position or balance, it shows the balances on all of the many asset accounts. Usually, they are grouped into similar line items. This way all the land, building, machinery and vehicle's assets are grouped together as "property, plant and equipment". And then, they are arranged according to how long they are expected to take to deliver benefits to the business.

Assets are not the only thing that show financial position. Assets of R1 million are great but not if you owe R1.2 million. So, financial position is also about the liabilities of the business. What sort of creditors does the business owe and how much? Again, the arrangements indicate how soon these debts will have to be settled. The difference between assets and liabilities – net asset value – shows what the business is worth to the owners: equity. After all, what you have got minus what you owe is what you are worth. This also means that what you have got is equal to what you are worth plus what you owe. In other words, assets have been funded by a mix of owner's equity and debt. That is why the equity section of the Statement of Financial Position appears between assets and liabilities.

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At first-year level, equity is usually split into just two components: the capital that the owners have contributed and the rest is called retained earnings or accumulated profit. You may know that it might get a little bit more complicated because equity can also include other reserves like a revaluation surplus created by an increase in the value of land. But the principle is the same, any increase in net asset value will mean an increase in equity, only this time we put it in its own special equity account.

Now remember that each item you see here is a balance; the value of that item on the reporting date. By comparing last year's balance with this year's balance we can see a movement in the balances. Some of these movements are easily explained. For example, trade receivables presumably increased because during the year, the business sold more items on credit than it received payment for. In other cases, the movements are the result of a lot of different types of transactions. And so, accountants use notes to the financial statements to show the reasons for the movement. Like this note about the reasons for the PPE balance. Now, there are two kinds of movements in balances, which investors and creditors are particularly interested in. I am talking about the movements on the equity accounts and the movements on the cash balances. In fact, investors and creditors are so interested that accountants have come up with two financial statements simply to show the movements in those two types of accounts.

Perhaps you can guess which two I am talking about. Let’s start with the equity accounts. It probably won’t surprise you to know that the statements, which describes the movements in the equity accounts is called Statement of Changes in Equity. (Hey, accountants are not paid to be creative.) Now, if you want to understand this statement, all you have to do is watch this:

See how in this Statement of Financial Position there are two equity accounts and a line showing total equity. See that they each have a balance at the end of the year and a balance at the beginning of the year? Well, a Statement of Changes in Equity just takes that information and swivels it so that Capital, Retained Earnings and Total of Equity each gets its own column and the relevant balances at the beginning and end of the year are shown at the top and the bottom of each column. So far the Statement of Changes just shows the same information as the Statement of Financial Position except now, it is on its side. The useful information comes in between the balances; it shows what has caused the movements. For example, in this case, a contribution of capital increased the balances on the capital’s account and distributions to the owner, known as drawings or dividends, depending on the type of business that decreased the Retained Earning balance.

The Statement of Changes in Equity also shows the movements in equity, which are not the result of transactions with owners. Wait a minute, we have got a name for that, haven’t we? When there are increases or decreases in Net Asset Value, not through transactions with the owner, we are talking about income and expenses, aren’t we?

In this example, the income and expenses are summarised in one line – profit, which increases Retained Earnings. This can get more complicated if you have items of the comprehensive income, which needs to be shown separately and may affect other reserves. For example, a revaluation gain on land may increase the revaluation surplus. But the principle is the same, all this statement does is to summarise the reasons for the movements in Net Asset Value shown on the Statement of Financial Position.

Now the changes in equity, which are not the result of transactions with owners, are massively important. If a business can increase the value of the business to owners without the money coming from owners then it has made the owners wealthier. In other words, income and expenses are such a big deal that investors and creditors are not going to be happy with a simple summary in the Statement of Changes in Equity. We need another Financial Statement to show the detail.

So, the Statement of Comprehensive Income or Income Statement contains all items of income or expense. Although most businesses have so many such items that they are grouped into different categories and even the order of items on the Statement differs from one business to another. Despite these differences you will always find profit, which shows the difference between almost all, if not all, of the items of income and expense. Also, it links up the the Statement of Changes in Equity, where we have already seen that it increases the Retained Earnings. Below profit there are sometimes items of other comprehensive income like a revaluation gain on land, which also link up with the Statement of Changes in Equity in the same way.

The two statements of financial performance that we have considered so far, the Statement of Changes in Equity and the Statement of Comprehensive Income, show the financial performance in terms of movement and Net Asset Value. That is like a video shot from one angle, it is just one view of financial performance that is the accrual basis view. The accrual basis requires income to be reported when it is earned and expenses to be reported when they are incurred. For example, when you make a credit sale you recognise the income and the expense on the day the Net Asset Value changes, which is the date of the sale rather than when the cash is collected from the customer or when the cash for the inventory is paid to the supplier. Now, the accrual basis is a very clever way to represent financial performance but it is not the only way, it is not the obvious way either. The obvious way would be to show the cash flows. After all, cash is very important. There is a reason we talk about businesses making money.

The Statement of Cash Flows abandons the accrual basis and reports financial performance on the cash basis using three main sections: operating, investing and financing cash flows. Basically, every transaction is reported purely in terms of its cash effects – if cash is received by the business during the period the Statement of Cash Flows reports a cash inflow and vice versa.

A lot of the figures are different from the figures on the Statement of Comprehensive Income. There are still movements. They are just movements in the cash balance. For example, when we made a credit sale, the upwards movements in the "trade receivables" account was shown in sales income on the Statement of Comprehensive Income. But it won't be there in the Statement of Cash Flows, instead all we see is the upwards movement in the cash balance when cash is actually received from customers.

The subtotals on each of the three sections add together to show the Net Cash inflow or outflow for the year. The statement finishes by indicating how this Net Flow has moved last year's cash balance to this year's cash balance. I do not have to tell you where else you will find these two balances, do I?

So all of the four financial statements taken together are an elegant way of showing investors and creditors the business's financial position and financial performance. If you can understand what each of the financial statements tells the users, and how and why they are linked up then you will be well on your way to understanding the big picture of accounting, the rest of it is just details. Thanks for listening and good luck with those details.