

7.1 Financial Reporting and Internal Control Regulations

Think About It

If you've worked a service job, like in the restaurant industry, you may notice the manager comparing the money at the end of a shift to the money at the beginning of that shift. This is to ensure that no money is missing and all funds are accounted for, so managers can accurately record the totals at the end of the day. Counting money from the register each shift is a small example of an internal control, an integral element to a federal law that regulates how companies report their financial standing: the Sarbanes-Oxley Act of 2002.

The Purpose of the Sarbanes-Oxley Act

In response to a number of financial scandals in the early 2000s, the federal government passed the **Sarbanes-Oxley Act of 2002**. This federal law, sometimes called the SOX Act or the Corporate Responsibility Act of 2002, established new requirements for all public companies in the U.S., setting stricter rules for boards of directors, accountants, and auditors. The primary purpose of the SOX Act was to hold management and boards of directors, the elected corporate body that acts in the interest of shareholders and conducts business oversight, accountable for the preparation and accuracy of a company's financial statements and to prevent fraud. **Fraud** is a company's knowing publication of incorrect information on its financial statements. The law also requires public accountants to remain independent from the clients they audit.

The SOX Act also established the **Public Company Accounting Oversight Board (PCAOB)** to oversee the audits of public companies in order to protect investors and the public interest at large. This marked the first time in the country's history that auditors were subject to external and independent oversight.

Sarbanes-Oxley and Internal Controls

Prior to the Sarbanes-Oxley Act, managers of companies caught participating in fraudulent activities were able to pass the blame onto other employees, claiming to be ignorant of wrongdoing. Managers can be held personally liable for retaliating against employees who expose potential fraud inside a business.

Financial Reporting and Internal Control Regulations (cont'd)

Sarbanes-Oxley and Internal Controls (cont'd)

The SOX Act also required internal controls to prevent fraud from occurring. **Internal controls** are policies and procedures that are created and enforced to ensure the reliability of accounting system and record keeping. That includes requiring management to certify that financial statements are accurate.

Sarbanes-Oxley and Corporate Governance

Corporate governance is the system by which management handles their responsibility toward shareholders. Under the SOX Act, company management is more responsible than before for the accuracy of financial reports and cannot pass on blame to other employees for fraudulent statements.

The bill set stricter rules requiring the storage and maintenance of certain business and financial records in addition to stricter penalties for misconduct, including the destruction or falsification of records. Any willful attempt to alter, destroy, falsify, or conceal financial data is punishable by significant fines and possible jail time. Other possible penalties include giving up company stock or being barred from holding similar titles with other public companies.

Sarbanes-Oxley Code of Ethics

Sarbanes-Oxley outlines a code of ethics for company leadership. A **code of ethics** is a set of rules for governing behavior. The SOX Act code of ethics deals with the chief executive officer (CEO) and chief financial officer (CFO) of the company. It includes limiting conflicts of interest in personal and professional relationships and avoiding the use of non-public knowledge to make personal transactions. A company's financial report should be fair, accurate, and timely, according to the law. Finally, financial officers are required to participate in audits and assist internal accountants. **Internal accountants** are accountants who prepare, analyze, and verify financial data for corporations with an emphasis on checking for fraud or waste.

Activity 7.1

The class will be split into 4 teams. Each Team will have a different company.

A different company accused and/or convicted of financial reporting fraud (e.g., Enron, WorldCom, Tyco, Adelphia, etc.) to each team.

Conduct research on its company, fraudulent activities that the company engaged in, and ways in which the Sarbanes-Oxley Act attempts to prevent those specific wrongdoings from occurring again.

Develop a one- to two-page written report detailing its findings. or 6 Page Google Slide with detailed info.

Link to Document:

7.2 Statement of Changes in Equity

Think About It

Suppose you lent your younger sibling money to start a lemonade stand. The lemonade stand is a great success all summer, and by the end, your sibling has made a good profit from their efforts. In fact, they have plenty of money to return to their investors – like you! – if they decide to conclude their enterprise, pay off any debts or obligations, and collect their remaining earnings. Because of this success, your sibling’s business has a great deal of value (or equity).

While their business ventures may not be quite as simple as a lemonade stand, leaders of businesses large and small must report their equity as it changes over time. To document the value of a company, we use an important financial report: the statement of changes in equity.

What Is a Statement of Changes in Equity?

The statement of changes in equity (also called an **equity statement**, statement of owner’s equity, statement of shareholders’ equity, or statement of retained earnings) is an important and required financial statement prepared annually. This statement reports all changes in equity over a given reporting period. **Equity** refers to the value of a business—it is the money that would be returned to shareholders if company assets were liquidated and debts paid off. (This value is also called book value or net worth.) Documenting changes in equity is an important part of managing a business, because it helps determine the financial position of a company and potentially provides opportunities for growth.

Relationship With the Income Statement

The equity statement is developed using information from the income statement. An income statement documents net income, also called “the bottom line” because it appears as the ultimate value at the end of the income

statement. **Net income**, or earnings, is the money that remains after operating expenses are subtracted from gross profit (in other words, a company's profit).

Using the net income from the income statement, the equity statement then shows how net income and dividends affect the financial position of a company over a period of time. **Dividends** are money paid to an investor or stockholder as earnings on an investment. (Like the money you might receive from your sibling's lemonade stand.) The net income left over after dividends have been paid to shareholders is called **retained earnings**. Retained earnings might be paid out to shareholders, or reinvested back into the company.

Statement of Changes in Equity (cont'd)

Relationship With the Balance Sheet

Just like businesses use the income statement's bottom line (net income) to develop the equity statement, so, too, do they use the equity statement's bottom line (equity) to develop the balance sheet. (Sometimes, because the equity statement is so connected to both the income statement and the balance sheet, it is included as part of either the income statement or balance sheet rather than appearing as its own, separate statement.)

A balance sheet captures the financial condition of a business at that particular moment by showing how much money a business has, how much it owes, and how much belongs to owners or stockholders. A business cannot calculate how much belongs to owners or stockholders (ending equity) on its balance sheet without the information provided on the equity statement.

Using the Statement of Changes in Equity

Not only is the information from the equity statement used to develop the income statement and balance sheet, it is also a crucial financial report used to assess a business's financial health and to plan for the continued success of a company. Because the equity statement provides information regarding a company's retained earnings, it can be used to improve confidence in a business and its profits.

Retained earnings can be used for many different purposes, so businesses must decide how to use that remaining money and how it can best serve the business. Business leadership often reinvests retained earnings in the business through the following ways:

- **Reducing debt.** To make money, businesses need to spend money—and to receive spending money, businesses often take out loans. Paying off debts decreases a business's liabilities.
- **Expanding existing business operations.** This includes opening a new store front, increasing production of existing products, buying more equipment, or hiring more employees.
- **Launching a new venture.** Businesses might choose to spend money on research and development of a new product, from household appliances to new food flavors. Or, that money could be used in preparation for a change that leads to improved business opportunities, such as an upcoming merger, acquisition, or partnership.

For a sample statement of changes in equity, follow this link:

7.2 Activity:

Individually conduct research online to locate the tutorial or article that you believe best describes statements of equity and retained earnings.

You will then be put in a team of 4. Members of each team should evaluate their teammates' tutorials and/or articles for completeness, accuracy, and clarity. Then, YOUR team should select the tutorial or article that best meets these criteria.

Link to best tutorial:

7.3 The Nature of Cash Flows

Think About It

Consider what might happen if there was no money coming into or going out of a business. That business probably wouldn't be "in business" for long, right? That's because the money going in and out of a business—called cash flows—is essential to business success and survival. Read on to learn more about the nature of cash flows and how it affects business operations.

The Importance of Cash Flows

Cash flows reflect the money that is going in and out of a business. Cash outflows are how a business spends its money, while cash inflows are how a business receives its money. Quite simply, businesses need cash to survive! Without cash flows, companies would quickly go under. Businesses need to maintain positive cash flows to operate and create value for investors. Additionally, they should have a good understanding of just how much cash is available and where money is going.

Sources of Cash Flows

Businesses make and spend money on a variety of different things. However, there are three main sources of cash inflows and outflows: operating activities, investment activities, and financing activities. These sources are explained in more detail below:

Operating activities. Operating cash flow includes the money involved in a business's ordinary activities. For a business to remain viable, this cash flow must be positive, as it indicates that the business can afford to pay its bills

and conduct business. Inflows from operating activities include money from sales and paid receivables. Outflows from operating activities include employee payroll, money paid to suppliers, depreciation, and taxes.

Investing activities. Investment cash flow includes the money involved in investment-related activities. This cash flow might be negative (reflecting significant investments) and is not always a red flag. Inflows from investing activities include selling or renting equipment, real estate, or investment securities. Outflows from investing activities include purchasing equipment, real estate, or investment securities.

Financing activities. Financing cash flow includes the money involved in funding the company and its capital. This cash flow indicates a business's financial strength and how well it is managed. Inflows from financing activities include receiving a loan for the business. Outflows from financing activities include paying toward the loan.

7.3 The Nature of Cash Flows (cont'd)

Accounts Receivable & Accounts Payable

Accounts receivable (AR) and accounts payable (AP) can both have a great deal of impact on the cash flow of a business. Accounts receivable is all monies owed to a company by its customers. If customers are paying their bills on time, then the business can rely on a steady stream of cash inflow. However, if customers aren't paying their debts on time (or at all), the company is missing out on the possession of that money. Accounts payable is all monies owed by the business to others, such as vendors or suppliers. Companies should pay back debts within the agreed upon time period, but they don't always choose to pay off their debts as soon as possible—instead, they often wait to pay back their creditors until closer to the debt's due date. By delaying the payment, management can keep more working capital (e.g., cash) on hand for other endeavors.

Cash Flow Statement

Business leadership should have a solid understanding of the company's financial health at any given time. One key financial document they use to track this health is the cash flow statement. It determines whether the business has sufficient funds to operate, pay expenses and loans, account for taxes, and purchase new assets. Cash flow statements can be prepared for different periods of time, and change depending on factors that influence revenue and expenses. Cash flow statements can help businesses spot trends and provide valuable insights to improve long-term decision-making. A detailed cash flow statement can help predict the future cash situation, improve budgeting choices, and show prospective investors the business is a worthy venture.

Effective Cash Flow Management

Given cash flow's importance to a business, it's crucial that companies manage cash inflows and outflows efficiently. Businesses must be proactive about managing cash flow, since it's not something that will just "work out" if not monitored.

Here are a few strategies for effective cash flow management:

- Monitor cash flow closely and frequently to identify any issues early.
- Grow your business strategically to avoid overextending and running out of cash.
- Have a fundamental understanding of basic business accounting.

- Send invoices to customers quickly to encourage timely cash inflows.
- Utilize technology that helps manage cash flow, especially for small business.
- Be prepared with a backup plan in case a worst-case scenario occurs.

7.3 Activity:

Find 2 news articles online that show examples of the three types of cash flows:

Operating activities, investing activities, and financing activities.

Then find one example of each.

Finally, you will share each example with the class, and briefly explain how the cash flow affects the business.

Article Links

1.

2.

Example of each

-
-
-

7.4 Preparing Cash Flow Statements

Think About It

One of the most important financial reports a business must prepare is the cash flow statement. Cash flow is the rate at which cash enters and leaves a business. There are many reasons to prepare cash flow statements, and it is important to understand the research and other factors that impact this preparation.

Why Prepare Cash Flow Statements?

The cash flow statement is a crucial indicator of a business's financial health. It determines whether the business has sufficient funds to operate, pay expenses and loans, account for taxes, and purchase new assets. Businesses

manage day-to-day operations by tracking and preparing cash flow statements. Cash flow statements can be prepared for different periods of time, and change depending on factors that influence revenue and expenses. Cash flow statements can help businesses spot trends and provide valuable insights to improve long-term decision-making. A detailed cash flow statement can help predict the future cash situation, improve budgeting choices, and show prospective investors the business is a worthy venture.

The Importance of Research

Accountants must conduct proper research before and throughout the process of preparing cash flow statements to ensure the numbers match up and accurately reflect the business's financial viability. Additionally, one essential factor businesses need to research is whether the indirect or direct method will be most effective when calculating their operating cash flow.

The indirect method accounts for revenues and expenses when they are incurred, which is based on accrual basis accounting. Most companies use this method, as it aligns with their current accounting practices. The indirect method involves showing the business's net income, then adjusting inflows and outflows, including depreciation, accounts payable and receivable, and inventory expenses, to calculate the total operating activities cash flow.

The direct method counts revenues and expenses when actual payments are made, which is cash basis accounting. This method is more complex and time-consuming, as it requires customer receipts, income tax payments, and payments to employees. However, the direct method offers a more detailed, insightful look into a business's finances.

Cash flow refers to the inflow and outflow of a business's money. There are numerous factors that affect the timing of a business's cash flow:

- Accounts receivable
- Accounts payable
- Taxes
- Sales
- Credit terms and policy
- Inventory
- Expenses
- Interest and investments

Procedures for Preparing Cash Flow Statements

To prepare a cash flow statement, follow these steps:

- **Determine the business's opening cash balance.** The opening balance for the current accounting period (e.g., year, quarter, etc.) is where the company left off in the previous accounting period, found on the prior period's balance sheet or cash flow statement.
- **Calculate the cash from operating activities.** This is the cash the business generates (e.g., selling products/services) and spends (e.g., paying employees and rent) during typical daily operating activities. This amount is added to or subtracted from the opening balance.
- **Calculate the cash from investing activities.** This is the cash generated from and spent on long-term assets, major equipment or property, and market securities. This sum is added to or subtracted from the operating activities amount.

- **Calculate the cash from financing activities.** This is the cash that moves between the business and its investors, creditors, and owners. This includes bonds, stocks, and dividends. This amount is added to the previous amounts.
- **Determine the business's closing cash balance.** To calculate the closing cash balance, add the prior amounts to determine whether there was a net decrease or increase to cash. This value is added to the beginning balance to determine the closing balance. This net cash movement is the total change in cash position for the business.

The steps above can be characterized by the following formula:

Opening cash balance + Cash flow from operating activities + Cash flow from investing activities + Cash flows from financing activities = Closing cash balance

For a sample cash flow statement, click here:

<https://corporatefinanceinstitute.com/resources/knowledge/accounting/cash-flow-statement%E2%80%8B/>

7.4 Activity

Get into a group of 3-4 students.

Each group will be assigned one section of the business's cash flow statement: cash from operating activities, cash from investing activities, or cash from financing activities. (In large classes, there will be multiple groups with the same assignment.)

Conduct online research and create a handout that includes 1) a definition of the assigned section, 2) examples of cash sources within this section, and 3) a graphic illustrating the assigned section.

- Make your presentation Professional

Use the Following [Google Slide Template](#):

7.5 Preparing Income Statements

Think About It

Along with the balance sheet and cash flow statement, the income statement is one of the most important financial reports a business must prepare. This report helps a business gauge its profitability by providing a review of its financial health over a given period.

Understanding the Income Statement

The **income statement** is a financial summary that shows how much money a business has made or lost over a period of time (annually, quarterly, monthly, etc.). It can also be called the profit-and-loss statement, statement of income, statement of earnings, statement of operations, and statement of revenue and expense. An income statement can provide valuable insight regarding a company's management, operations, and performance, especially compared to other businesses in the industry.

When reviewing an income statement, it is important to understand that amounts are calculated using the accrual method of accounting. The **accrual accounting method** records transactions at the time they occur, even if no money changes hands at the time. This means that income (or revenue) and cash received do not mean the same thing. Income/revenue is credit that is earned in a given time period, even if cash is not received at that time. Similarly, expenses (like cost of goods sold and operating expenses) and cash paid are not the same thing—just because expenses are recorded in a given time period does not mean that cash was paid at that time.

Single-Step and Multistep Processes

Information used to prepare the income statement is often found in accounting journals and ledgers. It is also a good idea to generate a trial balance report before preparing an income statement. A **trial balance** is a listing of a business's different accounts and their current balances, and it is often used to check the accuracy of journal and ledger entries.

Income statements can be prepared using either a single-step or multi-step process. The single-step process prepares a simplified report by using a single equation:

$$\text{Net Income} = (\text{Revenue} + \text{Gains}) - (\text{Expenses} + \text{Losses})$$

The multistep process of preparing an income statement uses multiple equations to determine the net income (profit) of a company. This can take more time and effort to prepare, but it provides a more detailed look into a company's financial wellbeing. More on the multistep process below.

Preparing Income Statements (cont'd)

Preparing the Income Statement

To prepare an income statement using the multi-step approach, follow these steps:

- **Determine a reporting period.** Many businesses choose to report their income statements on an annual, quarterly, or monthly basis. It's important to select a reporting timeframe that will be valuable to the company and compliant with any reporting regulations.
- **Calculate revenue.** Revenue is the total amount of money earned by a business. This section of the report includes any sales made from a business's goods and/or services, even if that money hasn't been received yet.
- **Calculate cost of goods sold.** This section of the report includes all of the costs the business incurred when obtaining and/or producing the goods and/or services the business sells. These costs include raw materials, packaging, shipping, labor, and supplies.
- **Calculate gross profit.** To calculate gross profit, subtract the business's cost of goods sold from the business's revenue. The amount leftover represents the company's total profit made before all other remaining expenses have been deducted. This calculation is represented by the following formula:
 - **Gross Profit = Revenue – Cost of Goods Sold**
- **Calculate operating expenses.** To complete this section of the income statement, add up all of the company's expenses involved in running the business—essentially, what expenses keep a business's doors open. This includes employee wages, utilities, and advertising.
- **Calculate net income.** Net income is the business's final profit for a given time period. This amount is very important, as it provides insight into a company's profitability. Net income is the money remaining after operating expenses are subtracted from a company's gross profit, which can be expressed through the following formula:
 - **Net Income = Gross Profit – Operating Expenses**

Here is an income statement for the fictitious company Brandie's Boutique and Day Spa:

The business's revenue equals \$6,019,040. This total includes all money that the business made, no matter what the source, for one year. By subtracting the cost of goods sold (\$3,912,376) from the revenue, the business is able to see its gross profit. And, when it also subtracts its operating expenses (\$1,846,668), the business is able to see its net income.

Brandie's Boutique and Day Spa Income Statement	
Revenue	\$6,019,040
Cost of Goods Sold	<u>- \$3,912,376</u>
Gross Profit	\$2,106,664
Operating Expenses	<u>- \$1,846,668</u>
Net Income	\$ 259,996

7.5 Activity

Your team has been hired by Brandie Bellerton to prepare an income statement for her boutique and day spa. Imagine that you have already prepared an income statement for Brandie's business. The income statement contains the following information:

- Revenue: \$6,019,040
- Cost of Goods Sold: \$3,912,376
- Gross Profit: \$2,106,664
- Operating Expenses: \$1,846,668
- Net Income: \$259,996

Since Brandie is not familiar with accounting, she has some questions about the terms used on the income statement. She wants the following questions answered and Brandie wants them in a **one-page response**.

- What is revenue?
- What is the cost of goods sold? Provide an example of a good Brandie would sell.
- What is gross profit? How is it calculated?
- What are operating expenses? Provide an example of an expense Brandie would incur for her business's operation.
- What is net income? How is it calculated?

7.6 Preparing Balance Sheets

Think About It

Mia has a weekly allowance of \$10 for doing chores around the house. At the end of each month, Mia records the amount of money that she has saved in a notebook. She also keeps track of things she has bought with the saved money. Once, Mia had to loan money to her mom who needed \$10 for gas. She has that recorded in her notebook, too. Mia is doing on a small scale what businesses do frequently to keep track of their own finances, which you'll read about below.

Balance Sheet Basics

A **balance sheet** is a snapshot of how much money a company has on hand, how much it owes, and how much belongs to its owners or stockholders. It describes a business's financial position at a certain point in time. Typically, it is reviewed at the end of an accounting period—the end of the month, the end of the quarter, or the end of the year.

The balance sheet displays a business's assets and liabilities. An **asset** is anything of value that a business owns, and a **liability** is a debt that is owed. This information can help business leaders and stakeholders make decisions because balance sheets describe a business's total worth, or **net book value**. A business's financial records that contain up-to-date information on assets and liabilities are used to prepare a balance sheet.

The Accounting Equation

The **accounting equation** is the essential ingredient to preparing a balance sheet. The equation shows the relationship between total assets, total liabilities, and business owners' or shareholders' equity. **Equity** is the net worth of a business or a firm. Owners' equity is used to describe private businesses. If a company is publicly traded, it would be known as "shareholders/stockholders' equity."

Total assets are the complete amount of assets owned, and **total liabilities** are all of the debts owed to others.

As a formula, the accounting equation is as follows: $Assets = Liabilities + Owners' Equity$. Another way to look at the accounting equation is this way: $Assets - Liabilities = Owners' Equity$.

The accounting equation only shows the total assets, total liabilities, and owners' equity in a business. To report their specific types of assets and liabilities, businesses use a **classified balance sheet**, which breaks down assets, liabilities, and equity into more specific categories.

The following assets can be included as individual line items under the assets category:

- Cash
- Copyrights, trademarks and patents
- Buildings and land
- Equipment
- Vehicles
- Inventory
- Materials and supplies
- Prepaid advertising, legal fees, insurance, etc.
- **Accounts receivable** (money owed to the business)
- Stocks and bonds

Some of the assets listed above are current assets like cash. **Current assets** are what a company possesses right now. A company could also have assets like office buildings that are considered non-current assets, meaning they have lifespans that are longer than one year. **Non-current assets** and fixed assets can be more difficult to convert into cash quickly. Items like accounts receivable and fixed assets use net realizable value when recorded on the balance sheet. **Net realizable value** is an amount that a business expects to receive if the item were to be sold right now.

The following are liabilities that could make up the total liabilities category:

- **Accounts payable** (outstanding bills the company needs to pay)
- Wages and salaries
- Mortgages

- Interest
- Outstanding loans
- Taxes
- Customer deposits (goods or services that have been paid for but not yet delivered)

Items like wages, salaries, and taxes are considered current liabilities because they are paid within a year. Items like mortgages or outstanding loans are non-current liabilities because they take longer than a year to pay off. All liabilities are added up at the end of the section to express the total liabilities on the balance sheet.

Examples of owner's equity or stockholder's/shareholder's equity on a classified balance sheet include capital, common stock, and retained earnings. For an example of what a completed classified balance sheet looks like, follow this link:

<https://www.accountingtools.com/articles/2017/5/17/the-balance-sheet>.

Activity 7.6

in a group of three find two different balance sheets from two separate companies online.

Compare the balance sheets. Pay attention to how each balance sheet is different, and how they are the same.

Answer: