Financial Accounting

Sixth Edition

Cash and Internal Controls

CHAPTER 4

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PART A

INTERNAL CONTROLS

Incorrect Financial Statements

- Reasons:
  - **Errors**—accidental errors in recording transactions or applying accounting rules
  - **Fraud**—a person intentionally deceives another person for personal gain or to damage that person
    - **Occupational fraud**: the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employer's resources

Illustration 4–1
Fraud Triangle

Opportunity — the situation allows the fraud to occur.

Motivation — someone feels the need to commit fraud, such as the need for money.

Rationalization — justification for the deceptive act by the one committing the fraud.

Internal Controls

- **Internal controls** attempt to eliminate the opportunity element of fraud
- Internal controls represent plans to:
  - Safeguard the company’s assets
  - Improve the accuracy and reliability of accounting information

Learning Objective 1

LO4–1 Discuss the impact of accounting scandals and the passage of the Sarbanes-Oxley Act.

Accounting Scandals and Response by Congress

- Managers are entrusted with the resources of both the company's lenders and owners
- Managers act as stewards or caretakers of the company's assets
- Some managers have shirked their ethical responsibilities
  - Top executives misused or misreported the company's funds

Accounting Fraud in U.S. History

Enron

Avoided reporting billions in debt and losses

WorldCom

Misclassified expenditures to overstate assets and profitability

Sarbanes-Oxley Act of 2002

- Passed by Congress
- Also known as the *Public Company Accounting Reform and Investor Protection Act of 2002*
- Applies to all companies that are required to file financial statements with the SEC
- Established guidelines related to:
  - Internal control procedures
  - Auditor-client relations

Illustration 4–2
Major Provisions of the Sarbanes-Oxley Act of 2002

Oversight board	The Public Company Accounting Oversight Board (PCAOB) has the authority to establish standards dealing with auditing, quality control, ethics, independence, and other activities relating to the preparation of audited financial reports. The board consists of five members who are appointed by the Securities and Exchange Commission.
Corporate executive accountability	Corporate executives must personally certify the company's financial statements and financial disclosures. Severe financial penalties and the possibility of imprisonment are consequences of fraudulent misstatement.
Nonaudit services	It's unlawful for the auditors of public companies to also perform certain nonaudit services, such as investment advising, for their clients.
Retention of work papers	Auditors of public companies must retain all work papers for seven years or face a prison term for willful violation.
Auditor rotation	The lead auditor in charge of auditing a particular company (referred to as the *audit partner*) must rotate off that company within five years and allow a new audit partner to take the lead.
Conflicts of interest	Audit firms are not allowed to audit public companies whose chief executives worked for the audit firm and participated in that company's audit during the preceding year.
Hiring of auditor	Audit firms are hired by the audit committee of the board of directors of the company, not by company management.
Internal control	Section 404 of the act requires (a) that company management document and assess the effectiveness of all internal control processes that could affect financial reporting and (b) that company auditors express an opinion on whether management's assessment of the effectiveness of internal control is fairly stated. Smaller companies are exempt from requirement (b).

Key Point

The accounting scandals in the early 2000s prompted passage of the Sarbanes-Oxley Act (SOX).

Among other stipulations, SOX sets forth a variety of guidelines related to auditor-client relations and additional internal controls.

Section 404, in particular, requires company management and auditors to document and assess the effectiveness of a company's internal controls.

Concept Check 4–1

Which of the following statements is NOT true of the Sarbanes-Oxley Act of 2002?

a. All companies in the U.S. fall under its provisions.

b. It helped establish guidelines for internal control procedures.

c. It helped establish corporate executive accountability.

d. It helped establish guidelines for auditor-client relations.

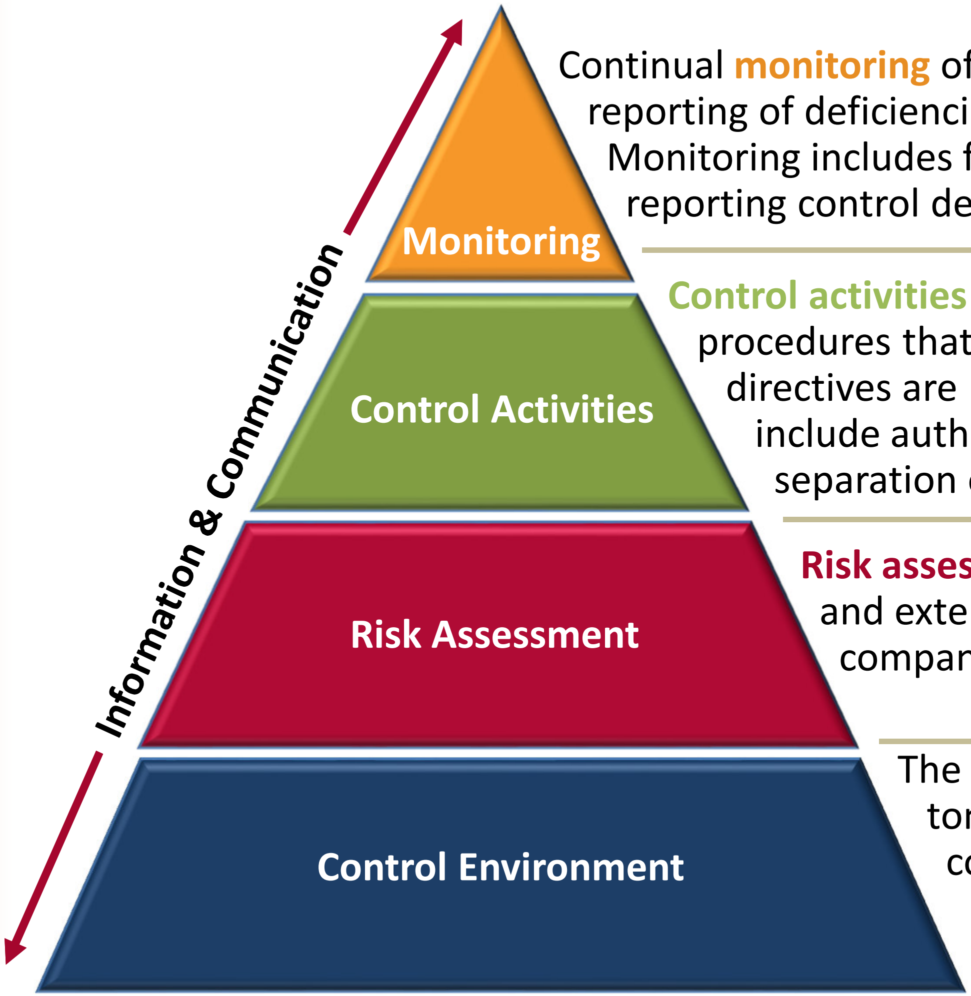
The Sarbanes Oxley Act of 2002 applies only to companies that are required to file financial statements with the SEC.

Learning Objective 2

LO4–2 Identify the components, responsibilities, and limitations of internal control.

Illustration 4–3
Components of Internal Control

Methods for collection of relevant information and communication in a timely manner, enabling people to carry out their responsibilities.



Continual **monitoring** of internal activities and reporting of deficiencies is required. Monitoring includes formal procedures for reporting control deficiencies.

Control activities are the policies and procedures that help ensure that management's directives are being carried out. These activities include authorizations, reconciliations, and separation of duties.

Risk assessment identifies and analyzes internal and external risk factors that could prevent a company's objectives from being achieved.

The **control environment** sets the overall ethical tone of the company with respect to internal control. It includes formal policies related to management's philosophy, assignment of responsibilities, and organizational structure.

Illustration 4–4

Live Nation's Discussion of Internal Controls Over Financial Reporting

LIVE NATION ENTERTAINMENT
Notes to the Financial Statement (excerpt)

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or internal controls will prevent all possible errors and fraud. Our disclosure controls and procedures are, however, designed to provide reasonable assurance of achieving their objectives, and our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are effective at that reasonable assurance level.

Components of Internal Control

- The overall attitudes and actions of management greatly affect the **control environment**.
- **Risk assessment** includes careful consideration of internal and external risk factors.
- **Control activities** include a variety of policies and procedures used to protect a company's assets.
- **Monitoring** of internal controls needs to occur on an ongoing basis.
- **Information and communication** depend on the reliability of the accounting information system itself.

Control Activities – Preventative Controls

- **Separation of duties** – A set of procedures intended to separate employees' duties for *authorizing transactions*, *recording transactions*, and *controlling* the related assets.
- **Physical controls** – A set of procedures that ensure assets and accounting records are kept safe.
- **Proper authorization** – A set of procedures designed to prevent improper use of the company's resources.
- **Employee management** – Providing employees with appropriate guidance to ensure they have the knowledge necessary to carry out their job duties.
- **E-commerce controls** – A set of procedures specifically designed to ensure only authorized personnel are able to conduct e-commerce transactions.

Control Activities – Detective Controls

- **Reconciliations** – Management should periodically determine whether the amount of physical assets of the company (cash, supplies, inventory, and other property) agree with the accounting records.
- **Performance reviews** – The actual performance of individuals or processes should be checked against their expected performance.
- **Audits** – Hire an independent auditor to assess the internal control procedures to detect any deficiencies or fraudulent behavior of employees.

Responsibilities for Internal Control

- **Top Executives**:
  - Everyone in a company has an impact on the operation and effectiveness of internal controls.
  - The top executives are the ones who must take final responsibility for their establishment and success.

Concept Check 4–2

If a company places cash receipts from the day in a safe or bank deposit box, this would be an example of:

a. Separation of duties

b. Physical control

c. Reconciliation

d. Performance review

This is an example of a physical control. Important items (like cash receipts) should be kept in safe places—like a safe or a bank deposit box.

Illustration 4–6

Excerpt from Regal Entertainment's Auditor's Report Related to Effectiveness of Internal Controls

LIVE NATION ENTERTIANMENT
Auditor's Report (excerpt)

We have audited Live Nation Entertainment, Inc.'s internal control over financial reporting as of December 31, 2019, based on criteria established in the Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). In our opinion, Live Nation Entertainment, Inc. (the Company) maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on the COSO criteria.

Limitations of Internal Control

- Even with the best internal control systems, financial misstatements can occur.
- Internal control systems are especially susceptible to **collusion.**
  - Collusion: Two or more people acting in coordination to circumvent internal controls
- Top-level employees who can override internal control procedures also have opportunity to commit fraud.
- Effective internal controls and ethical employees alone cannot ensure a company's success, or even survival.

Key Point

Internal control refers to a company's plan to improve the accuracy and reliability of accounting information and safeguard the company's assets.

Five key components to an internal control system are (1) control environment, (2) risk assessment, (3) control activities, (4) monitoring, and (5) information and communication.

Control activities include those designed to prevent or detect fraudulent or erroneous behavior.

Concept Check 4–3

Everyone in the company has an impact on the operations and effectiveness of internal control, but who must take final responsibility?

a. Auditors
b. Top executives
c. The firm's attorney
d. The majority shareholder

The top executives take final responsibility for the establishment and success of internal controls. In fact, the CEO and CFO of companies that are required to file financial statements with the SEC must sign a report each year assessing whether the internal controls are adequate.

PART B

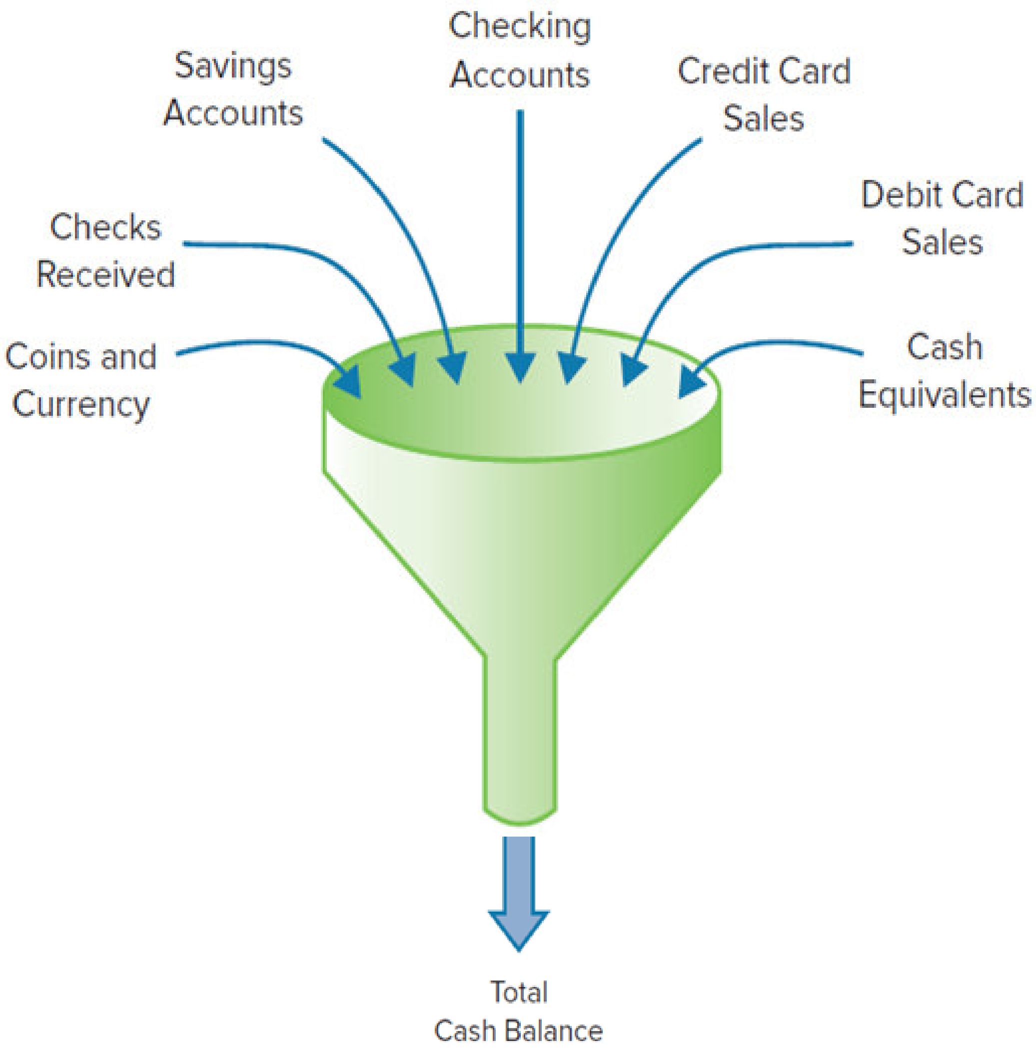
CASH

Learning Objective 3

LO4–3 Define cash and cash equivalents.

Illustration 4–7

Components of the Total Cash Bala



Key Point

Cash includes:

- Coins and currency, checks received, and balances in savings and checking accounts,
- Credit card and debit card sales, and
- **Cash equivalents**, defined as investments that *mature within three months from the date of purchase* (such as money market funds, Treasury bills, and certificates of deposit).

Concept Check 4–4

Which of the following would NOT be considered a cash equivalent?

a. Credit card sales for the day

b. Debit card sales for the day

c. Checks received from customers

d. Certificate of deposit (CD) that matures one year from now

Cash includes currency, coins, savings accounts, checking accounts, credit card sales, debit card sales, and other cash equivalents. Cash equivalents are generally defined as investments that mature within three months from the date of purchase, such as money market funds, treasury bills, and certificates of deposit. Since the CD doesn't mature until 1 year from now, it would NOT be considered a cash equivalent.

Learning Objective 4

LO4–4 Understand controls over cash receipts and cash disbursements.

Collections of Payments from Customers

- Cash and checks (“paper”)
- Credit cards and debit cards (“plastic”)
- Mobile payments
- Electronic funds transfers (EFTs)
- Prepaid cards
- Cryptocurrencies

Controls over Receipt of Cash and Checks

1. Open mail each day, and make a list of cash and checks received, including the amount and payer's name.
2. Designate an employee to deposit cash and checks into the company's bank account each day, different from the person who receives cash and checks.
3. Have another employee record cash receipts in the accounting records as soon as possible. Verify cash receipts by comparing the bank deposit slip with the accounting records.
4. Accept credit cards or debit cards, to limit the amount of cash employees handle.

Acceptance of Credit Cards

- The acceptance of *credit cards* provides an additional control by reducing employees' need to directly handle cash.
- Meanwhile, the credit card company deposits cash in the company's bank for the amount of the sale, less service fees.

Record Credit Card Sales

- A movie theatre accepts MasterCard as payment for $2,000 worth of movie tickets, and MasterCard charges the movie theatre a service fee of 3%.
- The service fee equals $60, or sales of $2,000 times 3%.

	Debit	Credit
Cash	**1,940**	
Service Fee Expense	**60**	
Service Revenue..		**2,000**
(Sell tickets with credit card and 3% service fee)		

Acceptance of Debit Cards

- Like credit cards, **debit cards** offer customers a way to purchase goods and services without a physical exchange of cash.
- They differ, however, in that most debit cards (sometimes referred to as check cards) work just like a check and withdraw funds directly from the cardholder’s bank account at the time of use.
- Similar to credit cards, the use of debit cards by customers results in a fee being charged to the retailer.
- However, the fees charged for debit cards are typically much lower than those charged for credit cards.

Common Mistake

- The term *debit card* can cause some confusion for someone in the first accounting course.
- Throughout this course, we refer to an increase in cash as a *debit* to cash. However, using your debit card will result in a decrease in your cash account.
- The term *debit card* refers to the bank's liability to the company being decreased (debited) when the company uses a debit card. Don't let this confuse you.

Controls Over Cash Disbursements (1 of 2)

1. Make all disbursements, other than very small ones, by check, debit card, or credit card. This provides a permanent record of all disbursements.
2. Authorize all expenditures before purchase and verify the accuracy of the purchase itself. The employee who authorizes payment should not also be the employee who prepares the check.
3. Make sure checks are serially numbered and signed only by authorized employees. Require two signatures for larger checks.

Controls Over Cash Disbursements (2 of 2)

4. Periodically compare amounts shown in the debit card and credit card statements with purchase receipts. The employee verifying the accuracy of the debit card and credit card statements should not also be the employee responsible for actual purchases.
5. Set maximum purchase limits on debit cards and credit cards. Give approval to purchase above these amounts only to upper-level employees.
6. Employees responsible for making cash disbursements should not also be in charge of cash receipts.

Record Purchase of Advertising with Cash, Check, or Debit Card

- A movie theatre pays $1,000 to advertise its show times.
- The movie theatre pays with cash, a check, or a debit card.

	Debit	Credit
Advertising Expense	**1,000**	
Cash		**1,000**
(Purchase advertising with cash, check, or debit card)		

Record Purchase of Advertising with Credit Card

- A movie theatre pays $1,000 to advertise its show times.
- The movie theatre pays with cash, a check, or a debit card.

	Debit	Credit
Advertising Expense	**1,000**	
Accounts Payable		**1,000**
(Purchase advertising with cash, check, or debit card)		

Key Point

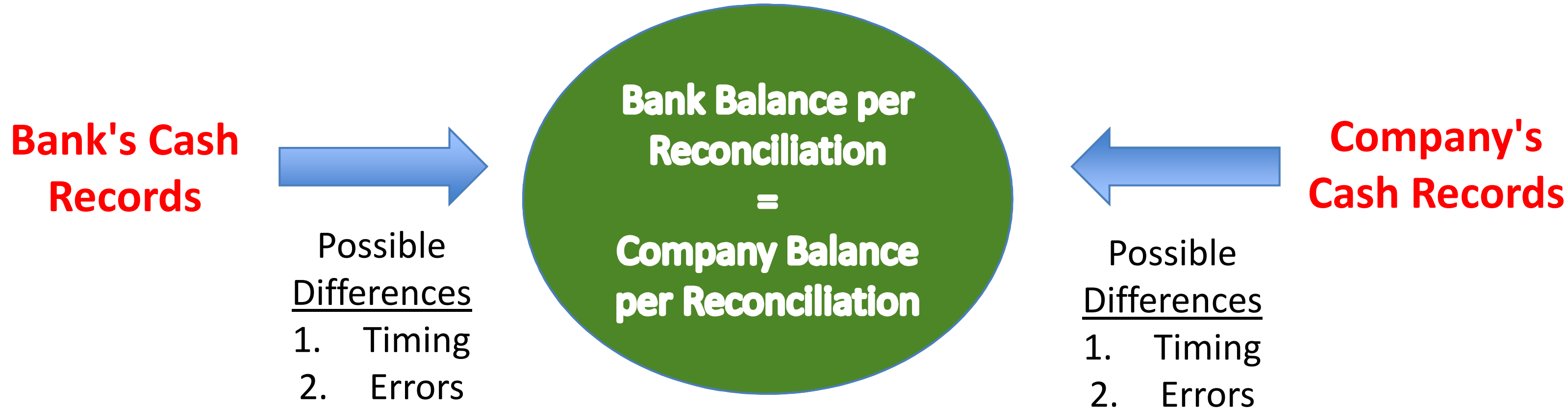
- Because cash is the asset of a company most susceptible to employee fraud, controls over cash receipts and cash disbursements are an important part of a company's overall internal control system.
- Important controls over cash receipts include separation of duties for those who handle cash and independent verification of cash receipts.
- Important controls over cash disbursements include payment by check, credit card, or debit card, separation of duties, and various authorization and documentation procedures.

Learning Objective 5

LO4–5 Reconcile a bank statement.

Bank Reconciliation

The balance of cash in the company's records may **not** equal the balance of cash in the bank's records.



- A **bank reconciliation** matches the balance of cash in the bank with the balance of cash in the company's own records.
- **Timing differences** in cash occur when the company records transactions *before or after* the bank records the same transactions.
- **Errors** can be made either by the company or its bank and may be accidental or intentional.

Illustration 4–8
Company Records of Cash Activities

STARLIGHT PRODUCTIONS
Cash Account Records
March 1, 2024, to March 31, 2024

Cash Receipts

Date	Description	Amount
3/5	Sales	$3,600
3/12	Sales	5,900
3/16	Sales	4,200
3/20	Sales	7,400
3/24	Sales	6,300
3/16	Sales	8,500
		$35,900

Cash Disbursements

Date	Description	Memo	Amount
3/1	EFT	Salaries	$7,200
3/5	EFT	Rent	4,500
3/10	DC	Advertising	3,000
3/17	CHK 294	Supplies	2,700
3/23	DC	Repairs	2,100
3/28	CHK 295	Insurance	5,400
			$24,900

Summary of Transactions

Beginning Cash Balance March 1, 2024		Cash Receipts		Cash Disbursements		Ending Cash Balance March 31, 2024
$23,600	+	$35,900	–	$24,900	=	$34,600

Illustration 4–9
Bank Statement

P.O. Box 26788
Odessa, TX 79760
(432) 799-BANK

First Bank
A Name You Can Trust

Member FDIC

Account Holder: Starlight Productions
221B Baker Street
Odessa, TX 79760

Account Number: 4061009619
Statement Date: March 31, 2024

Account Summary

Beginning Balance March 1, 2024	Deposits and Credits No.	Deposits and Credits Total	Withdrawals and Debits No.	Withdrawals and Debits Total	Ending Balance March 31, 2024
$23,600	4	$29,600	8	$26,800	$26,400

Account Details

Deposits and Credits

Date	Amount	Description
3/8	$3,600	DEP
3/14	5,900	DEP
3/19	4,200	DEP
3/22	7,400	DEP
3/26	6,300	DEP
3/29	2,000	NOTE
3/29	200	INT
	$29,600	

Withdrawals and Debits

Date	Amount	Description
3/1	$7,200	EFT
3/5	4,500	EFT
3/10	3,300	DC
3/21	2,700	CHK 294
3/23	2,100	DC
3/27	4,100	NSF
3/31	2,800	SF
3/31	100	
	$26,800	

Desc.
DEP Customer deposit
NOTE Note collected
EFT Electronic funds transfer
INT Interest earned
CHK Customer check
DC Debit card
SF Service fees
NSF Nonsufficient funds

Common Mistake

- Notice that bank statements refer to an increase (or deposit) in the cash balance as a credit and a decrease (or withdrawal) as a debit. This terminology is the opposite of that used in financial accounting, where debit refers to an increase in cash and credit refers to a decrease in cash.
- The reason for the difference in terminology is a difference in perspective.
  - When a company makes a deposit, it views this as an increase to cash, so it records a debit to the Cash account. However, the bank views this same deposit as an increase in the amount owed to the company, or a liability, which is recorded as a credit.
  - Similarly, a withdrawal of cash from the bank is viewed by the company as a decrease to its Cash account, so it is recorded with a credit, but the bank views this withdrawal as a decrease to the amount owed to the company, so it debits its liability.

Reconciling the Bank Account

Reconciling the bank account involves the following three steps:

1. Reconcile the **bank's** cash balance.
2. Reconcile the **company's** cash balance.
3. Update the company's Cash account by recording items identified in step 2.

Step 1: Reconcile the *Bank's* Cash Balance

- Cash transactions recorded by the company, but not yet recorded by its bank:
  - **Deposits outstanding**: Cash receipts of the company that have not been added to the bank's record of the company's balance
  - **Checks outstanding**: Checks the company has written that have not been subtracted from the bank's record of the company's balance
  - Bank errors

Illustration 4–10
Differences in Cash Collections

Company Records

Cash Receipts

Date	Description	Amount
3/5	Sales	$3,600
3/12	Sales	5,900
3/16	Sales	4,200
3/20	Sales	7,400
3/24	Sales	6,300
3/30	Sales	8,500

Deposit Outstanding
not in bank statement

Bank Statement

Deposits and Credits

Date	Amount	Desc.
3/8	$3,600	DEP
3/14	5,900	DEP
3/19	4,200	DEP
3/22	7,400	DEP
3/26	6,300	DEP
3/29	2,000	NOTE
3/29	200	INT

Cash increases
not in company records

Illustration 4–11
Differences in Cash Payments

Company Records			
Cash Disbursements			
Date	Desc.	Memo	Amount
3/1	EFT	Salaries	$7,200
3/5	EFT	Rent	4,500
3/10	DC	Advertising	3,000
3/17	CHK 294	Supplies	2,700
3/23	DC	Repairs	2,100
3/28	CHK 295	Insurance	5,400

Checks Outstanding
not in bank statement

Bank Statement		
Cash Disbursements		
Date	Amount	Desc.
3/1	$7,200	EFT
3/5	4,500	EFT
3/10	3,300	DC
3/21	2,700	CHK 294
3/23	2,100	DC
3/27	4,100	EFT
3/31	2,800	NSF
3/31	100	SF

Company error of $300

Cash decreases
not in company records

Illustration 4–12
Bank Reconciliation

STARLIGHT Productions
Bank Reconciliation
March 31, 2024

Bank's Cash Balance		***Company's Cash Balance***	
Per bank statement	$26,400	Per general ledger	$34,600
		Note Received	2,000
Deposits outstanding:	8,500	Interest earned from note	200
		EFT for utilities	(4,100)
Checks outstanding:	(5,400)	NSF Check from customer	(2,800)
		Service fee	(100)
		Corrected advertising expense	(300)
		Company balance per reconciliation	$29,500
Bank balance per reconciliation	$29,500		

Step 3: Update company records

Step 1 Reconciled Step 2

Common Mistake

- Students sometimes mistake an NSF check from a customer as a bad check written by the company instead of one written to the company.
- When an NSF check occurs, the company has deposited a customer’s check but the customer did not have enough funds to cover the check.
- The company must adjust its balance of cash downward to reverse the increase in cash it recorded at the time of deposit.
- The effect of this bounced customer check creates an account receivable for the company until the customer honors the funds it owes.

Concept Check 4–5

Which of the following items would be found on the "bank side," or the left-hand side, of the bank reconciliation?

a. Interest income received on the account

b. Deposits outstanding

c. NSF check from a customer

d. Service fee charged by the bank

The common items that are shown on the left side of the bank reconciliation include deposits outstanding, checks outstanding, and bank errors. All of the other items would appear on the "company's side," or the right-hand side, of the bank reconciliation.

Concept Check 4–6

How would an NSF check from a customer be treated on a bank reconciliation?

a. Addition on the bank side

b. Deduction on the bank side

c. Addition on the company side

d. Deduction on the company side

An NSF check would be shown on the company's side—the right side—and it would be shown as a deduction. This is because when the company originally deposited the customer's check, they increased the Cash account. Now that the check has been discovered to be an NSF check, or a nonsufficient funds check, the company must reverse the cash out of its books, resulting in a decrease, or a deduction, on the company's side of the bank reconciliation.

Step 3: Update the Company's Cash Account (1 of 3)

Update the balance in the company's Cash account to adjust for items used to reconcile the company's cash balance (right side of Illustration 4-12).

- **Debit Cash** for items that add to the balance.
- **Credit Cash** for items that subtract from the balance.

Step 3: Update the Company's Cash Account (2 of 3)

Record items that *increase* cash:

March 31, 2024	Debit	Credit
Cash	**2,200**	
Notes Receivable.......................................		**2,000**
Interest Receivable (from note)................		**200**
(Record collection on note and interest earned)		

Record items that *decrease* cash:

March 31, 2024	Debit	Credit
Utilities Expense...	**4,100**	
Accounts Receivable..	**2,800**	
Service Fee Expense	**100**	
Advertising Expense	**300**	
Cash		**7,300**
(Record utilities payment, NSF check, advertising, bank service fee, and correction for rent)		

Step 3: Update the Company's Cash Account (3 of 3)

- In the uncommon event that the two balances at the end of the bank reconciliation schedule are not equal, management investigates the discrepancy to check for wrongdoing or errors by company employees or the bank.
- If the company cannot resolve the discrepancy, it records the difference to either Miscellaneous Expense or Miscellaneous Revenue, depending on whether it has a debit or credit balance.

Common Mistake

- Some students try to update the Cash account for deposits outstanding, checks outstanding, or a bank error.
- The company does not need to adjust for these items related to reconciling the bank's balance because they are already properly recorded in the company's accounting records.

Illustration 4-13

Summary of Items Included in the Bank Reconciliation

	Bank's Cash Balance	Company's Cash Balance
	Per bank statement	Per general ledger
Timing Differences	+ Deposits outstanding − Checks outstanding	+ Notes received by bank + Interest received − Unrecorded payments − NSF checks from customers − Bank service fees
Errors	± Bank errors	± Company errors
	= **Bank balance per reconciliation**	= **Company balance per reconciliation**

Key Point

- In a bank reconciliation we reconcile the bank's cash balance for:
  1) Cash transactions already recorded by the company but not yet recorded by the bank and
  2) Bank errors.
- Similarly, we reconcile the company's cash balance for:
  1) Cash transactions already recorded by the bank but not yet recorded by the company and
  2) Company errors.
- After we complete the reconciliations, the amounts for the bank balance and the company balance should be equal.
- Any adjustments to the company's balance need to be recorded.

Concept Check 4–7

How would an NSF check from a customer be recorded in the accounting records?

a. Debit Accounts Receivable; Credit Cash
b. Debit Cash; Credit Accounts Receivable
c. Debit Accounts Payable; Credit Cash
d. Debit Cash; Credit Miscellaneous Expense

Accounts Receivable is debited in order to increase that asset account to show that the customer who paid with an NSF check still owes the company money. The Cash account is credited because the company must adjust its balance of cash downward to reverse the increase in cash it recorded at the time it received the check from the customer.

Learning Objective 6

LO4–6 Account for employee purchases.

Employee Purchases

- **Petty cash fund**: small amount of cash kept on hand to pay for minor purchases
  - ❑ Accounting for the petty cash fund involves:
    - Establishing the fund
    - Recognizing expenditures from the fund
    - Replenishing the fund
- **Company-issued debit and credit cards**
  - ❑ Debit cards (and checks) captured in the bank reconciliation
  - ❑ Credit card purchases need to be recorded

Establish a Petty Cash Fund

- Establish a petty cash fund of $200.
- Remove cash from the bank and place it on hand at the company.

May 1	Debit	Credit
Petty Cash (on hand) ………………………………	**200**	
Cash (checking account) ……………………..		**200**
(Establish the petty cash fund)		

Employee Purchases

Petty Cash Fund (Cash)	
Item	Amount
Lunch	$60
Delivery	$90

Purchasing Manager (Credit Card)	
Item	Amount
Supplies	$800
Supplies	$600

Marketing Manager (Credit Card)	
Item	Amount
Advertising	$1,500
Postage	$1,200

May 31	Debit	Credit
Supplies ($800 + $600)	**1,400**	
Advertising Expense	**1,500**	
Postage Expense	**1,200**	
Accounts Payable		**4,100**
(Recognize employee expenditures with credit cards)		

May 31	Debit	Credit
Entertainment Expense...	**60**	
Delivery Expense	**90**	
Cash..		**150**
(Recognize employee expenditures from the petty cash fund)		

Key Point

- To make purchases on behalf of the company, some employees are allowed to use debit cards and credit cards (purchase cards), write checks, and spend available cash on hand (petty cash fund).
- At the end of the period, all employee purchases are recorded, and the petty cash fund is replenished.

Internal Controls over Employee Expenditures

- Employees should be required to provide receipts and justification for those receipts on a timely basis.
- A separate employee reviews receipts and supporting documents to ensure all expenditures are made appropriately.
- Credit card receipts are reconciled to credit card statements.
- Spending limits are placed on employees who are authorized to use a company credit card or have access to company cash. Major expenditures require pre-approval through formal purchasing procedures.
- Only those employees that need to make timely business expenditures should receive authorization.

PART C

STATEMENT OF CASH FLOWS

Learning Objective 7

LO4–7 Identify the major inflows and outflows of cash.

Reporting Cash

Balance Sheet

- Balance of cash
- Snapshot at end of period
- Current or noncurrent asset

Statement of Cash Flows

- Inflows/Outflows
- Covers a period of time
- Operating, Investing, and Financing

Statement of Cash Flows

- **Operating activities**
  - Cash transactions involving revenues and expenses
  - Examples: Cash received from customers, cash paid for rent, utilities, supplies, and salaries
- **Investing activities**
  - Cash investments in long-term assets and investment securities
  - Examples: Purchase or sale of land, equipment, and buildings for cash
- **Financing activities**
  - Transactions designed to finance the business through borrowing and owner investment
  - Examples: Issue common stock or pay dividends; borrow or repay debt

Illustration 4–14
External Transactions of Eagle Soccer Academy

Transaction	External Transactions in December	Type of Activity	Is Cash Involved?	Inflow or Outflow?
(1)	Sell shares of common stock for $200,000 to obtain the funds necessary to start the business.	Financing	YES	Inflow
(2)	Borrow $100,000 from the local bank and sign a note promising to repay the full amount of the debt in three years.	Financing	YES	Inflow
(3)	Purchase equipment necessary for giving soccer training, $120,000 cash.	Investing	YES	Outflow
(4)	Pay one year of rent in advance, $60,000 ($5,000 per month).	Operating	YES	Outflow
(5)	Purchase supplies on account, $23,000.	Operating	NO	—
(6)	Provide soccer training to customers for cash, $43,000.	Operating	YES	Inflow
(7)	Provide soccer training to customers on account,	Operating	NO	—
	$20,000.	Operating	YES	Inflow
(8)	Receive cash in advance for 12 soccer training			
	sessions to be given in the future, $6,000.	Operating	YES	Outflow
(9)	Pay salaries to employees, $28,000.	Financing	YES	Outflow
(10)	Pay cash dividends of $4,000 to shareholders.			

Illustration 4–15

Statement of Cash Flows for Eagle Soccer Academy

EAGLE SOCCER ACADEMY Statement of Cash Flows For the period ended December 31, 2024		
Cash Flows from Operating Activities		
Cash inflows:		
From customers [6 and 8]	$ 49,000	
Cash outflows:		
For salaries [9]	(28,000)	
For rent [4]	(60,000)	
Net cash flows from operating activities		$ (39,000)
Cash Flows from Investing Activities		
Purchase equipment [3]	(120,000)	
Net cash flows from investing activities		(120,000)
Cash Flows from Financing Activities		
Issue common stock [1]	200,000	
Borrow from bank [2]	100,000	
Pay dividends [10]	(4,000)	
Net cash flows from financing activities		296,000
Net increase in cash		137,000
Cash at the beginning of the period		-0-
Cash at the end of the period		**$ 137,000**

Key Point

The statement of cash flows reports all cash activities for the period.

- Operating activities include those transactions involving revenue and expense activities.
- Investing activities include cash investments in long-term assets and investment securities.
- Financing activities include transactions designed to finance the business through borrowing and owner investment.

Concept Check 4–8

Which of the following items would be categorized as an investing activity on a statement of cash flows?

a. Borrowed money from the local bank by signing a note to repay the full amount two years later

b. Paid for supplies in cash

c. Paid for the purchase of equipment using cash

d. Paid salaries to employees

Cash flows from investing activities include the purchase or sale of long-term assets. The purchase of equipment using cash would be shown in the investing activities section—as a decrease. Borrowing money would be shown in the financing activities section, and the purchase of supplies and payment of salaries would be in the operating activities section.

ANALYSIS

CASH ANALYSIS

Live Nation Entertainment vs. AMC Networks

Learning Objective 8

LO4–8 Demonstrate the link between cash reported in the balance sheet and cash reported in the statement of cash flows.

Cash Reporting

($ in millions)		
Balance Sheet:	**Live Nation Entertainment**	**AMC Networks**
Cash and cash equivalents (ending)	$2,474.2	$816.2
Cash and cash equivalents (beginning)	2,378.2	554.9
Change in cash for the year	**$ 96.0**	**$ 261.3**
Statement of Cash Flows:		
Operating cash flows	$469.8	$483.7
Investing cash flows	(691.0)	(89.7)
Financing cash flows	328.9	(131.1)
Foreign currency effects	(11.7)	(1.6)
Net cash flows for the year	**$ 96.0**	**$ 261.3**

Cash Holdings

($ in millions)		
	Live Nation Entertainment	AMC Networks
Cash and cash equivalents	$2,474.2	$ 816.2
Noncash assets	$8,501.4	$4,780.5
Ratio	29.1%	17.1%

Concept Check 4–9

Which of the following statements is true?

a. Having too much cash represents idle resources that are not being used to produce revenues.

b. One way to assess cash holdings is to compare cash assets to noncash assets.

c. In recent years cash holdings have increased tremendously.

d. All of the above are true.

All of the above statements about cash are true.

End of Chapter 4