6. A prepaid expense is:
   - A. an Asset
   - B. Owner's Equity
   - C. a Liability

7. Is LIFO/FIFO a method of:
   - A. Inventory Evaluation
   - B. Profit Ratio
   - C. Financing

8. Which would you find on an Income Statement?
   - A. Expense
   - B. Fixed Asset
   - C. Liability

9. Which of the following expenses does not affect your cash position in running a business:
   - A. Lease Expense
   - B. Advertising Expense
   - C. Depreciation Expense

10. Which of the following is a basic accounting equation:
    - A. Net Worth = Assets + Profits
    - B. Gross Profit - Sales = Gross Profit Margin
    - C. Assets = Liabilities + Owner's Equity

CHAPTER 1

Remember how you learned to make money as a kid?

There was baby-sitting and delivering newspapers. Shoveling snow off the neighbors' sidewalk and driveway. Mowing lawns and taking care of other people's pets and plants when they went on vacation.

There is one business which, chances are, almost every kid tries at least once in his or her life. A tried and true operation as American as baseball and Mom's apple pie.

The Lemonade Stand.

It's this world of childhood, of lemonade stands and sunny days that we use in *The Accounting Game*. It's hand-made signs and scraps of lumber turned into a humble yet proud establishment. It's when saving up enough of your own money for a bike or a piece of sports equipment or horseback-riding lessons seemed the most important goal in the world. It's when you had your first inkling about money, and wished you understood everything you needed to know about it.

Now is your chance to go back, and learn what you need to know about the language of business, which goes by the name of Accounting.

So, find a quiet space and relax. Read a paragraph of the italicized passage below, then close your eyes and visualize what you've just read. When you're ready, go on to the next section, and the next...

Let yourself slowly go back in time…

Let's go back, all the way back to grade school. Picture yourself somewhere between five to ten years old. Let yourself remember what your childhood grade school looked like. If you went to more than one school, just pick out your favorite.

It's the last day of school. The sun is streaming through the classroom window. You can't wait for the final bell to ring one last time—then you'll be free! Free to run out the door with all your friends!

You're young and safe and eager. Everything is possible. You feel creative, curious, and excited, and know your success in life is absolutely assured.

Let this picture settle into your mind. Take a deep breath. Enjoy it.

The final school bell rings. You tell your teacher to have a good summer, and you rush out the door. It's so warm and wonderful outside! The sky is blue and you look up and see a few white, puffy, clouds decorating the view like a happy cartoon.

Kids are laughing. Lawnmowers are buzzing. Birds are chirping.

You can smell fresh cut grass and the scent of flowers.

You feel great.

You reach home and go inside. Since it's a special day, your mom or dad is home to meet you.

You're hot and excited, so you say, "What's to drink?"

And your mom or dad replies, "You're in luck! I just bought some lemons and some sugar so let's make some fresh-squeezed lemonade."

You get out a great big pitcher, fill it with water and ice, squeeze up some lemons, measure out the sugar, and mix up a batch of great tasting lemonade.

This is going to be one fun summer!

Take a moment and let this thought settle. Take a deep breath.

You take your drink outside and sit under your favorite tree. The lemonade tastes out of this world!

Then it hits you—people will pay good money for lemonade like this!

Ready? Good!

In the garage is the stuff you need to make a lemonade stand: two wooden fruit crates turned on their ends, some old cans of paint and brushes, a hammer and some nails. You take an hour or two to put your stand together. It's fun working with your hands and watching something of your own devising take shape. When you finish, you take a close look at your new place of business. If there's a finer lemonade stand in the world, you sure haven't seen it!

Here's your very own lemonade stand. Find some markers or stickers, and go ahead and decorate it, if you wish. Make it distinctively your own.

Now that your place of business is ready, you need a product—and that takes money! You run to your bedroom and shake out all the quarters and nickels and dimes from your piggy bank.

It adds up to FIVE DOLLARS!

You transfer the money to the closest equivalent you can find to a bulletproof, x-ray proof, robber proof, impossible-to-open safety deposit apparatus—an old cigar box your uncle was about to throw out.

You don't want to mess with all those coins, so your mom or dad graciously exchanges all of them for five, crisp one-dollar bills. The five dollars go into the cigar box bank for safe-keeping. In case anyone doesn't know the cigar box is off-limits, you take a marker and write on it:

PRIVATE PROPERTY! KEEP OUT(OR DIE)!

Okay, your money is safe. What do we call those five one-dollar bills? CASH!

And what color is cash? Green!

Now that you're going to be rich, how are you going to keep track of the hundreds—no, millions! BILLIONS!—of dollars you're going to make selling lemonade? You need some paper and a pencil, for sure. You need some way to keep a record of what money goes in and out of your business. This record keeping is what accounting is all about.

You know enough about the world to know that one way grownups keep track of numbers is to keep score—like in baseball or golf, or whether your mom or dad last cleaned up after the dog in the back yard.

You decide to create a scorecard for your business.

Your scorecard allows you to keep track of things happening in your business. To better understand how money flows in and out of a business, though, we need a scorecard that shows two things: WHAT WE HAVE and WHO OWNS IT. Which means we need to draw a line down the middle of the scorecard. On the left side you'll track things and stuff you have and use in your business. On the right side you'll track who owns that stuff. So, your scorecard looks like this:

WHAT WE HAVE	WHO OWNS IT

The left side represents WHAT WE HAVE.

The right side of our scoreboard represents WHO OWNS IT.

Now that we have a proper scorecard, let's back up a moment. You start the business with some Cash, specifically five dollars.

Who has it?

You're right—you do! And, no doubt, you had to scrimp and save and keep your room clean and remind your parents a bunch of times to remember that the tooth fairy *always* leaves you some money when you lose a tooth. You worked hard for that five bucks! It's yours and nobody else's. Which means that it goes on the left side of the scorecard, as $5 in Cash. But it also goes on the right side since you own the $5. But what will you call this $5?

The whole idea is to invest the five bucks in your lemonade stand. Right?

So, what should we call the money that you originally shook from the piggy bank to invest in the lemonade stand?

How about "ORIGINAL INVESTMENT"?

Who owns the Original Investment? You, as the owner, do. So it goes on the right side of our scorecard.

Let's write in what's happened, so far. Enter the five dollars in Cash on the left side and enter the five dollars in Original Investment on the right side. Next, enter the totals on the last line of each side.

WHAT WE HAVE		WHO OWNS IT	
CASH		ORIGINAL INVESTMENT	
TOTAL		TOTAL	

Notice anything about the two sides?

They're equal. The left side equals the right side.

You now know an important rule about this financial scorecard. The left side will always, ALWAYS equal the right side!

Repeat this rule, please. Tape it to your forehead. Put it under your pillow at night, so you will remember it in your sleep:

THE LEFT SIDE ALWAYS EQUALS THE RIGHT SIDE!

So far, so good. The weather is great outside and you're ready to rock and roll! You can close your eyes and see the customers lining up around the block to sample your great tasting lemonade…until you realize that starting a lemonade stand will cost more than the original investment of five dollars because you have to buy stuff to make your lemonade.

Who is most kids' personal banker?

Right, Mom and Dad.

So you go to one of them (you know which one is more likely to say yes), and you say, "Here's your chance to teach me the real value of a dollar. Here's your chance to invest in a business sure to make lots of money. Here's your chance to help a budding billionaire. Here's your chance to keep me out of your hair until dinnertime!"

One of the reasons works, and Mom and Dad fork over TEN DOLLARS.

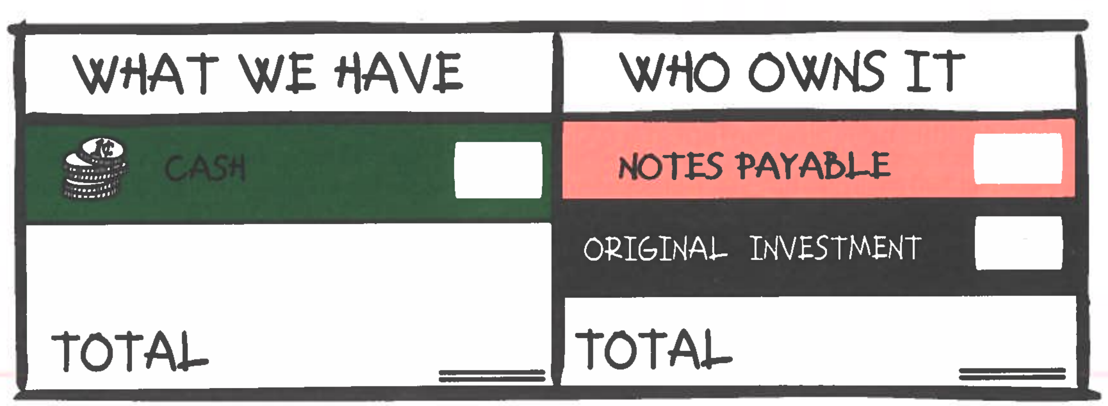
You're halfway out the door when Mom calls, "Hey, that ten dollars isn't a gift! It's a loan!"

You stop short. "A loan?" you repeat, making the word sound as disappointing as possible. "What's the matter? Don't you love me?"

"Nice try," Mom says. This is all part of teaching you something about the real world. Okay, you still have the money, even after Mom makes you sign a piece of paper that says "IOU" at the top.

Still, the ten dollars is yours to use, so you can add it to your Cash under What We Have.

But you also owe it to Mom. So, since you don't, in fact, "own" the ten dollars, we need to create a new category on the right side (Who Owns It) of the scorecard. You have, in fact, just signed a "note" that is "payable" to your mom. Businesses have a name for an IOU. It's called Notes Payable. Go ahead and record these transactions.



So, we have the left side which represents what you have and use. And what do you have? Cash.

And how much cash so far? Fifteen dollars.

Businesses have a name for the WHAT WE HAVE. Do you know it? Assets.

So, from now on, we'll use Assets as our heading for the left side.

On the right side, who owns that cash? You own five and your bankers (Mom and Dad) own how much? Ten.

Since there are two owners on the right half, we will draw a horizontal line that divides the right side into two parts. The upper right side represents the people that the business owes money to…or to whom you are LIABLE. Are you going to have to pay back the ten dollars to Mom or Dad? (You'd better, if you want to see your next birthday!) So, are you liable to them for $10? Yes. Which is why, from now on, we'll label the top part of the right side, LIABILITIES. Notice we will use the color pink for liabilities.

The lower right side represents the portion of the business you own; right now, that is your Original Investment. What do some people call the part of the business owned by the owners? Make a check mark by the answer below. (Hint: there may be more than one answer.)

- Equity
- Owner's Equity
- Stockholders' Equity
- Net Worth

Did you make a check in front of all of the above? You should, because they're all the same thing. For our sake, we're going to call this lower right side, Owner's Equity, and represent it with the color black.

So, the right side has two parts: Liabilities (what you owe others) and Owner's Equity (what's yours).

Remember we said the left side always equals the right side? Well, here's the next accounting rule to remember:

Assets = Liabilities + Owner's Equity

Repeat this equation. Write it on the palm of your hand. Put it under a magnet on the fridge. Program it as your computer screensaver.

Here's your scorecard again, with the proper accounting terms.

ASSETS		LIABILITIES	
CASH	$15.00	NOTES PAYABLE	$10.00
		OWNER'S EQUITY	
		ORIGINAL INVESTMENT	$ 5.00
TOTAL ASSETS	$15.00	TOTAL LIABILITIES & OWNER'S EQUITY	$15.00

Before moving on—does the left side still equal the right side? It should. Always! Always! Always!

You're doing great. And, hopefully, you're having fun. You're making discoveries, maybe seeing things clearly for the first time.

What's a good way to capture such a beautiful moment? How about by taking a snapshot.

What period of time does a snapshot record? Check one:

- A moment
- Longer than a moment

The answer is: A MOMENT. Snapshots give us an image of where we are right NOW. This scorecard is like a snapshot. It gives us an image, frozen at a particular moment, of a business's financial position—what you have and where it came from. So, this scorecard shows a moment in time, and the two sides are equal—or, as they say, "in balance." So, from now on, let's call this scorecard…

A BALANCE SHEET!

But, for the moment, enough of this philosophical stuff about time and nitpicking over words—we're here to start a lemonade stand!

Having the money to start your business, you tell your mom and dad that you're biking to the store for supplies. The money in your pocket or pack feels enormous! You bike as fast as you can, so you can spend the money before you somehow lose it. Or before any robber is stupid enough to even try and catch you on your fleeting bike.

You make it to your neighborhood grocery store. It's run by Mr. Pappy Parker, whom everyone calls "Pappy." He has a large friendly face and a big nose. His eyes are blue, his eyebrows bushy gray. He's bald and proud of it. Entering Pappy's store, you feel like the happiest kid in the world.

You check your pocket or pack. The fifteen dollars is still there. Phe-ew! You take out the folded piece of paper on which (with your mom and dad's help) you've written the supplies you need to open your lemonade stand.

50 lemons
5 pounds of sugar
2 gallons of water

The water you can get for free from your kitchen. The lemons and sugar you have to buy at Pappy's store.

Lemons sell for twenty cents apiece. Sugar sells at forty cents per pound.

You're pretty good at math, so go ahead and add up the cost of the goods you need to make lemonade:

50 lemons at 20¢ each = $ ______

5 pounds of sugar at 40¢ per pound= $ ______

2 gallons of water free

Total Purchases = $ ______

Having paid Pappy (who wishes you the best of luck with your new business), you load your supplies in your pack for the return trip. At home, you unload your supplies in the kitchen. Then, before you forget, you do a new scorecard that reflects the money spent buying goods to make your product. Since you spent twelve dollars on supplies, you need to take that amount out of Cash and record it somewhere new under Assets, since you're now the proud owner of fifty lemons and five pounds of sugar.

What do business people call the raw materials used in producing a product? Here's a hint. The word starts with "I" and ends with "Y." Need another hint? The inside letters are "N-V-E-N-T-O-R."

Did you guess "Inventory"? If so, you're absolutely right!

Inventory is a term for the raw materials, goods in process, and finished goods that a business plans to sell. Since you will use the lemons and sugar in your business, they are considered assets. So, Inventory is an Asset.

Take a moment and fill in the scorecard.

ASSETS		LIABILITIES	
CASH		NOTES PAYABLE	
		OWNER'S EQUITY	
INVENTORY		ORIGINAL INVESTMENT	
TOTAL ASSETS		TOTAL LIABILITIES & OWNER'S EQUITY	

Take at look at the last scorecard. Your cash is down, but it's been converted into inventory. In other words, you exchanged one asset for another.

Did this exchange change your total Assets? No. Your total Assets remain at fifteen dollars.

Was the right side of the scorecard affected by your trip to the store? No. The total Liabilities and Owner's Equity remains at fifteen dollars.

Does the left side equal the right side? Yes!

So, you're in balance!

It's time to make the lemonade.

Being careful not to waste a drop of lemon juice or a speck of sugar, being careful not to spill after you add the water, you discover that fifty lemons plus five pounds of sugar plus two gallons of water make enough lemonade to fill sixty glasses.

Let's put this into an equation, to determine what your COST OF PRODUCTION is.

50 lemons @ 20¢ each	$______
5 lbs. Sugar @ 40¢/lb.	$______
+ 2 gal. Water,	No Charge
60 Glasses=	$ ______

Now that we know your total Cost Of Production, let's figure out the cost per glass, or UNIT COST:

COST of Production $____ / # of glasses ____ = Cost per Unit (Glass) $_____

Hopefully, you came out with a Unit Cost of twenty cents. (Divide $12.00 by 60 glasses.)

You now know that it costs you twenty cents to produce one glass of lemonade.

Not just a glass of ordinary lemonade, but, in your humble opinion, the world's best glass of lemonade.

Then you ask yourself, "What will people pay for a glass of the world's best lemonade?" You certainly need to charge more than it cost you, otherwise you won't stay in business for long. But how much more?

You ask around. You ask your family and your friends and your neighbors and your dog or pet turtle. You think about what restaurants charge for drinks. You remember that last summer the kid down the street (who you don't like) got a dollar for his lemonade which was made from some awful-tasting powder mix. Not surprisingly (and to your secret delight), he only made a few dollars, and only because his parents felt sorry for him and bought a few glasses which they barely choked down.

Your product is excellent. Still, you don't want to charge so much as to scare away business. So, after concluding your research and pondering this important matter for a second or two, you decide to charge fifty cents a glass.

Finally, the big day arrives. The day your lemonade stand opens for business.

It's a warm, sunny, glorious day, full of promise, and there's, like, hundreds of people out walking their dogs and riding bikes and doing chores. Best of all, they all look incredibly thirsty!

In just a couple of hours, your cigar box starts to fill with quarters, dimes, nickels, pennies—and dollars! You can barely keep up with the demand. Your arm is about to fall off from pouring so many glasses of icy, cold, delicious, fresh, totally natural and organic lemonade, but you don't care because business is so good!

By the time you close up for the day, you've sold fifty—as in 5-0—glasses of lemonade! You add up all of the coins and dollars.

You sold twenty-five dollars of lemonade, on only your first day! Life doesn't get much better than this.

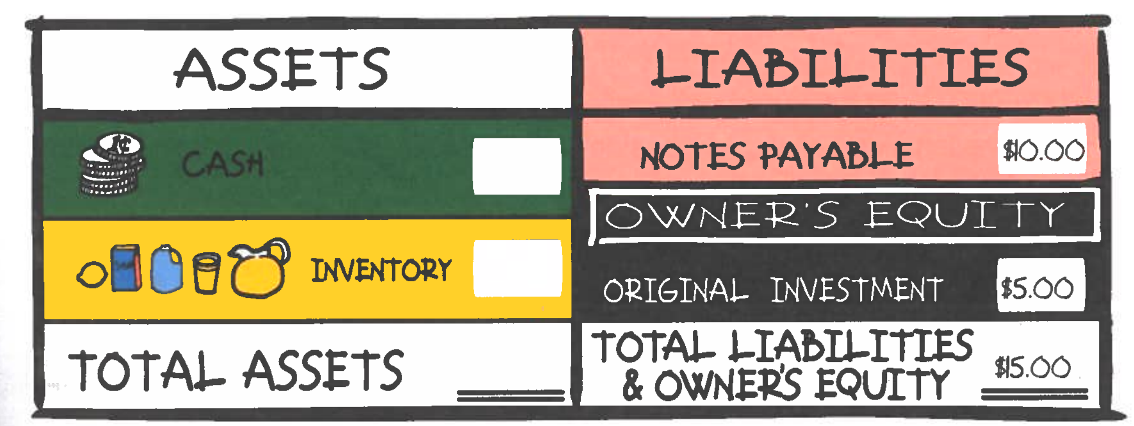
Then you remember that you had to spend money to make the lemonade. It cost 20¢ per glass, so it cost $10 to make 50 glasses. Now you figure if it cost $10 and you sold it for $25, you have $15 above and beyond your costs. Do you know what that's called? Profit or Earnings, right. In order to figure out your earnings, you need to subtract the COST OF GOODS SOLD (what it cost to make the fifty glasses of lemonade you sold) from your SALES (the money brought in by selling lemonade). The result of this subtraction is what business people call GROSS PROFIT.

Sales	$____
Cost of Goods Sold (50 glasses @ 20¢ each)	$____
Gross Profit (Earnings so far)	$____

Let's reflect the day's business on a scorecard.

Remember, you sold fifty glasses of lemonade, which cost you ten dollars in Inventory to produce. Thus, the amount in Inventory was substantially reduced.

In return, though, in came twenty-five dollars of Cash, representing the sales of fifty glasses. Go ahead and record these changes.



Does the left side equal the right side? No.

How much more do you have on the left side than the right side? Fifteen dollars.

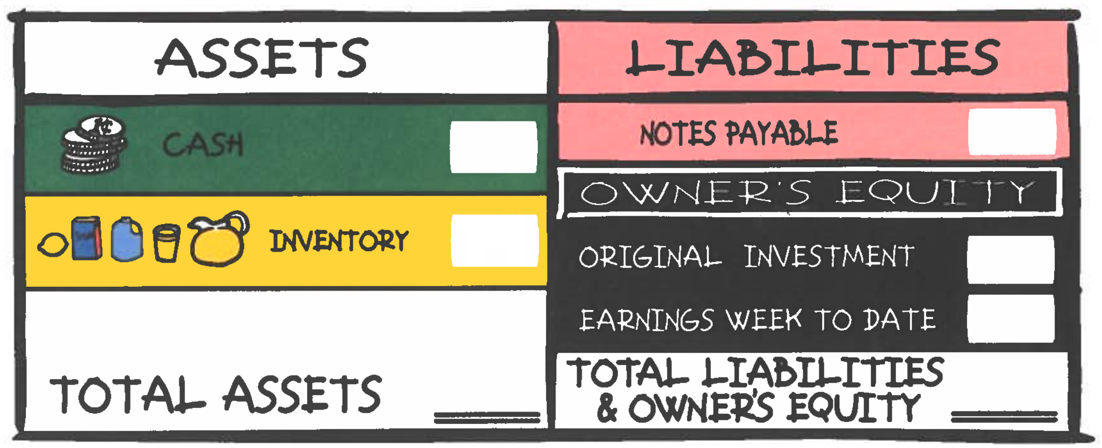
Who owns that fifteen dollars? You do.

So we add $15 to Owner's Equity. But the earned $15 was not part of the Original Investment. So, what do you think we need to do? Yes, add another category to

Owner's Equity. We earned that $15, so we're going to add EARNINGS WEEK TO DATE to the Owner's Equity section.

Reflect your Earnings Week To Date on the right side of the next scorecard. Then add up the new total Liabilities and Owner's Equity.

Now, how much is on the left side? Thirty dollars.



How much is on the right side? Thirty dollars.

Does the left side equal the right side? Yes.

What basic rule of accounting does this represent? Assets = Liabilities + Owner's Equity.

When did you earn that fifteen dollars? Just now.

And, who do the earnings belong to? Me, me, me!

Have things changed on your scorecard? And how! So, take another mental snapshot, one that records your first day running a lemonade stand—and making a profit!

That evening, as you practically have the money you made already spent in your mind, Mom and Dad drop a bombshell.

Those glasses you used at your lemonade stand, the ones you handled so carefully and afterwards washed 'til they sparkled and returned to the cupboard without as much as a scratch or chip on them—the glasses you *borrowed* from the kitchen—guess what.

Mom and Dad want to give you a lesson about running a business, and, without warning, decide to charge you a GLASS RENTAL FEE of two dollars!! Talk about tough love! You keep your mouth shut, but secretly you're convinced that Mom or Dad saw you making a profit and now want a piece of the action!

Worse yet, the next day, your best friend (or the kid you thought was your best friend) announces that he or she wants to be paid one dollar for a sign he or she painted for the lemonade stand.

Well, you decide, two can play this game! That afternoon, you decide you want to move the stand off your front yard, to the neighbors at the corner, which is sure to attract more business. Only problem is, the neighbors have been none too happy with you ever since they paid you to water their lawn while they were on vacation and you left the water on for about, oh, five hours too long and flooded their basement. But, hey, that was last summer, when you were just some silly kid. Now you're a budding businessperson running your own enterprise.

Nervous as a cat in a dog kennel, you knock on the neighbors' door. You explain your situation. To your relief, nobody mentions the flooded basement. They're impressed with your initiative, and suggest a fair price for the use of their front yard.

Now that you're a real business person, with real sales and expenses, you pay the neighbors two dollars to rent a spot on their lawn.

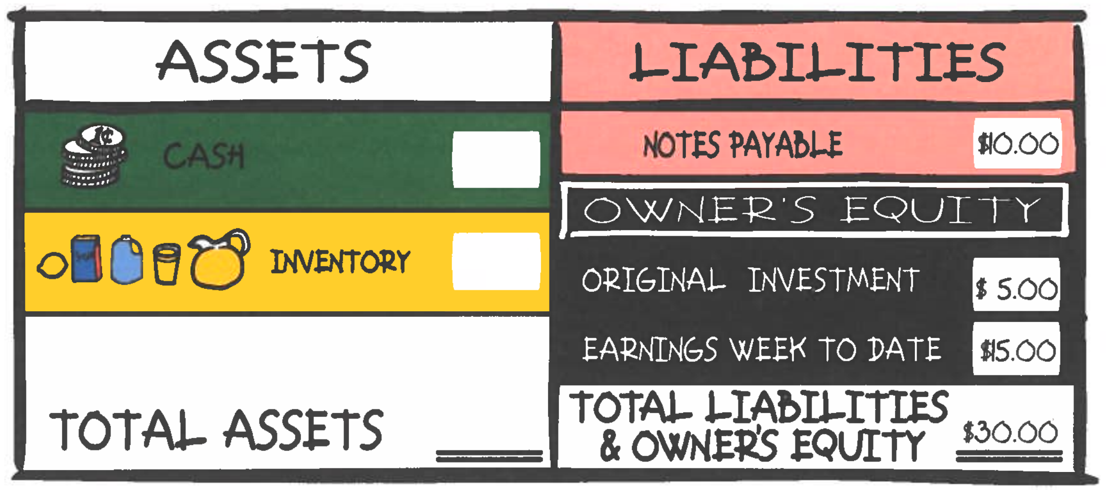
Two dollars for glass rental. A dollar for advertising. Another two dollars to rent the location.

Stop and figure out your EXPENSES.

Glass Rental		$______
Advertising		$______
Rent		$______
Total Expenses	=	$______

Expenses are the costs of doing business other than those related to producing your product. You have to pay these expenses, regardless of how much or how little lemonade you make or sell. Things like glass rental, advertising, rent, and other things not directly related to the cost of making your product are in this category.

You pay your expenses out of Cash. Record the change on the next scorecard.

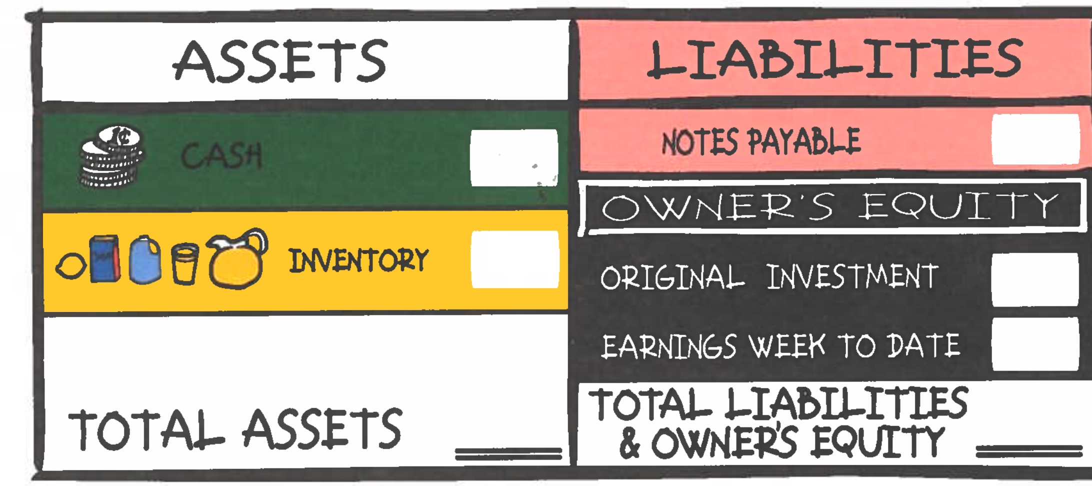


Does the left side equal the right side? No.

In order to make both sides equal, you need to take five dollars off the right side. How about taking it out of the ten dollars you owe in Notes Payable? On second thought, the way Mom and Dad are acting, you might have to pay a finance charge for the original loan if you even broach the possibility!

What will the expenses reduce? Expenses reduce earnings.

So, you need to reduce your Earnings Week to Date by the amount you've incurred as Expenses in that period. Do so on the next score card.



Now, does the left side equal the right? Yes!

Your cash is dropping but you still have enough left to pay off the ten-dollar IOU owed to Mom and Dad. You decide to do it, knowing your lemonade business will soon be challenging the likes of Nike, Disney, and Coca-Cola; even Microsoft!

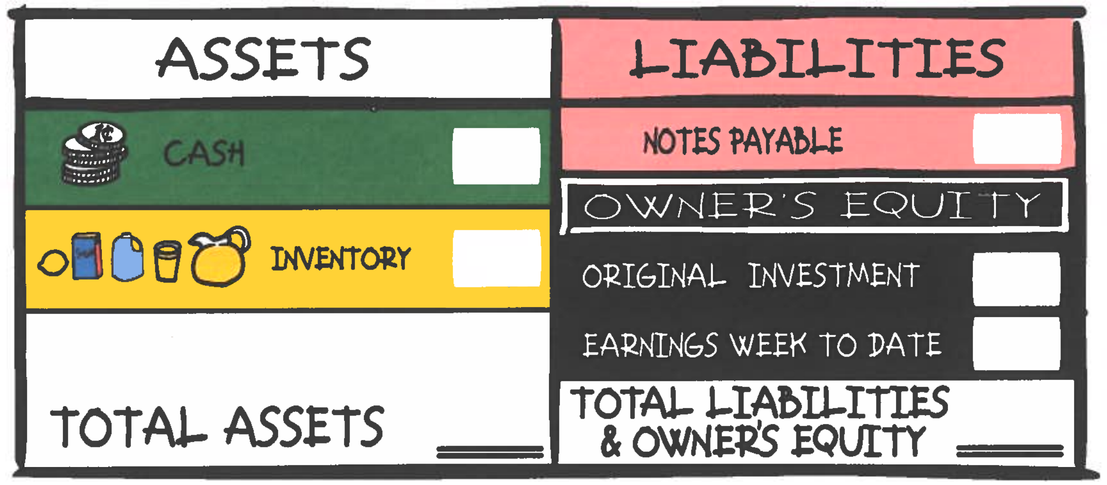
You find the least wrinkled dollar bills and count out ten of them. Then you put them inside a card, which reads:

Thanks for the loan! I love you!

The card, in turn, goes into an envelope, which you seal and present to Mom and Dad.

They open the envelope, read the card and pocket the ten bucks with a big smile. "You did good. We're so proud of you!" They both give you a big hug. It's a proud, proud day! They give you back the IOU, which you tear up. Life doesn't get much better than this!

To pay off the IOU, you took ten dollars from Cash. But it allows you to reduce to zero the amount owed to Notes Payable. Record this transaction on the next scorecard.



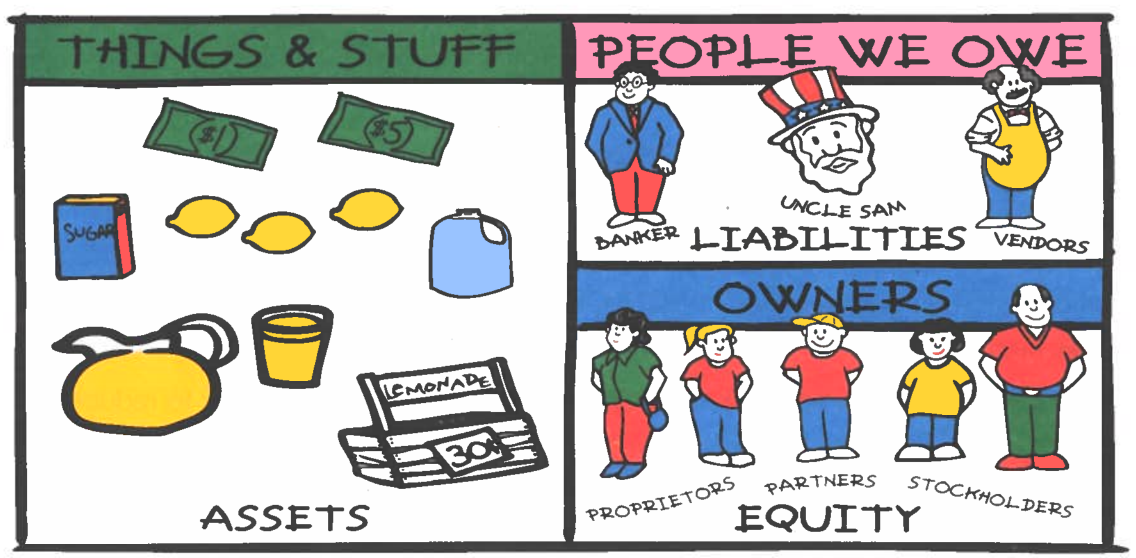
Does the left side equal the right side? It does.

So, what kind of scorecard is this? A Balance Sheet.

And what does a balance sheet always have to do? Balance.

Let's look at the purpose of a balance sheet.

The left side is Assets. Assets as a word isn't very kid-friendly. So, think of assets as THINGS AND STUFF.



The right side is Liabilities and Owner's Equity. Some more not very kid-friendly words. Liabilities represents the people you owe money to. And Owner's Equity is

what you, as the owner of the business, own. Who owns things? Well, people, of course. So, think of the right side as PEOPLE.

Thus, the purpose of the Balance Sheet is to connect things to people. It shows you the things you have in your business. Then it connects the things you have to the people who own or have a claim on those things.

Now, go back and count how many Balance Sheets you filled out during this first week of your lemonade business. A lot! Because you filled one out for each transaction.

Would you normally fill out a Balance Sheet every single time you have a transaction? No.

How often a Balance Sheet is filled out varies from business to business. Banks, since they handle a great deal of money, do it on a daily basis. Some other businesses do it weekly, monthly, quarterly, and yearly. (A year is considered the basic accounting cycle.)

Since you plan to continue selling lemonade through the summer, we will use a week as our accounting period and do balance sheets with each activity.

Boy, you're doing great! But does a Balance Sheet tell you everything that happens in a business? Look back at your last Balance Sheet.

What happened this week at your lemonade stand that isn't recorded on the Balance Sheet?

Does the Balance Sheet show you what your sales were for the week? No. Does it tell you what the Cost of Goods Sold is? Nope.

Did you buy some inventory this week? Yes. Remember the trip to the store for supplies?

Did you sell some of your product? Sure did!

Does the balance sheet tell you how much Inventory you bought and sold? No.

Does it tell you how much you paid for all your Expenses (like the glass rental, advertising, and rent for using the neighbors' lawn)? No way!

Does it tell you how you made your Earnings? No. NO! And enough already with these questions!

Would a business want to know all of these things? You bet! The problem is, you can't find them by looking at a balance sheet. What will we need to do?

Create another scorecard.

We learned that a Balance Sheet shows us a moment in time, like a snapshot, but we need for our second scorecard to give us a record of events happening over a period of time. Events like buying inventory, making your product, selling it, and incurring expenses are happening over time.

What type of camera records a period of time? Something in the act of happening?

A movie or video camera, of course.

So, we need a financial scorecard that acts like a motion picture. It will cover a period of time and shows motion. It has a beginning and end, just like a movie or video.

Luckily, this second type of scorecard exists, and it goes by a number of names. Do any on this list sound familiar?

Operating Statement.

Income Statement.

Profit & Loss (or P & L) Statement.

All of these terms represent the same type of financial statement. But, for our purposes, let's go with Income Statement.

If you need a break—maybe all of this talk about lemonade has made you incredibly thirsty—now's a good time. If you do take a break longer than a few minutes, you may want to review this section before moving ahead.

If, on the other hand, you have the stamina of a camel, next we're going to take up the Income Statement.