CHAPTER 4

Now that you're a pro at mixing lemonade, you make up a good sized batch. The batch takes fifty lemons (@ 20¢/each) and five pounds of sugar (@ 40¢/lb.), to make sixty glasses. What's the cost of production?

Before we answer, let's add another element. So far, you have made all your own lemonade, but this morning you decided to take off some time to go biking with friends. Still, you want to have the lemonade stand opened as soon as you return.

So, you ask your older sister if she'll make the lemonade for you. Most of the time you and your sister are pretty good buddies. But, suddenly, with your friends waiting outside, she turns into Scrooge!

"Why should I do you any favors?" she asks.

"Come on," you plead. "Just this once. I promise I won't bug you the next time you're on the phone."

"That's not good enough," she replies. "I'm no dummy. I've heard all that cash rattling in the cigar box. You have to pay me if you want your lemonade ready."

Well, she has you now. Boy, wait until you're rich and famous! See her come crawling for a favor then! But that's a few years down the road, and now your friends are screaming for you to hurry up.

"You win," you say with a sigh. "How much do you want?"

She smiles. She never is very modest in victory. "I want one dollar to make 60 glasses."

First, you get angry at her smugness, then, you force yourself to calm down and decide to pay it. After all, business is business. "Fine," you agree.

You give her the buck and head out the door. Once on your bike, with your friends, you reason this out. A dollar in labor cost is too much for sixty glasses—and it will lower your profit. But you figure you can afford it just this once.

A while later, refreshed from your ride, you return in time for the afternoon sales and see, to your relief, that your sister has done her job well. There in the refrigerator are 60 glasses of fresh lemonade. Say, maybe this boss thing isn't so bad, after all!

Seriously, let's look at our Inventory. We've got two types of Inventory here. What do we call the lemons and sugar? Raw materials.

And what kind of inventory is lemonade? Finished goods.

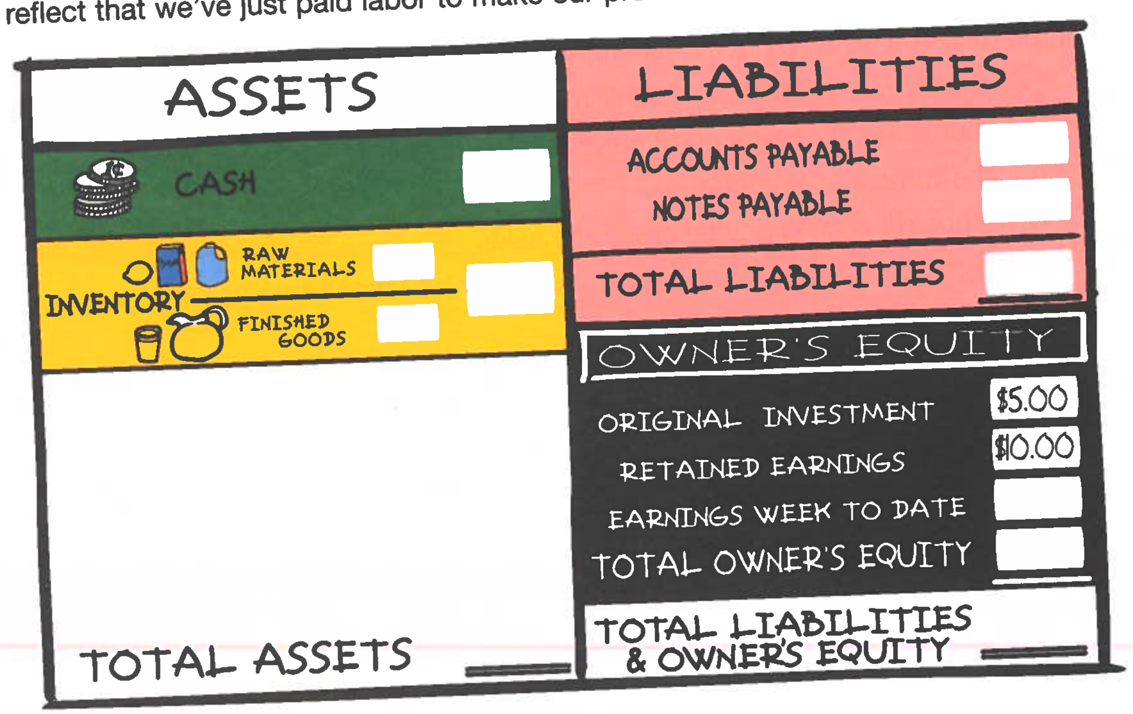
Now, while we (or Big Sister) were making it, what kind of inventory was it? Work-in-process—or WIP. Work-in-process is a big item for manufacturing companies.

We go from raw materials to work-in-process to finished goods.

We didn't use up all of our raw materials, though, for this batch. As a result, we have both raw materials and finished goods in our inventory. Are the raw materials considered available for sale? Yes.

For record-keeping purposes, all Inventory is available for sale.

Before we greet our afternoon customers, let's fill out another Balance Sheet to reflect that we've just paid labor to make our product.



How did you account for the labor? It reduced Cash by $1.00.

Here, though, is where it gets a little tricky. Many people would say, let's expense it and reduce our earnings.

However, in this case, you cannot expense the dollar—and you may know why. It has to do with the job Big Sister was doing—specifically her labor was to produce your product. Literally, her labor increased the value of the Inventory—so, in truth, you should have taken the $1 from Cash and added $1 to Inventory. As a result, Cash is now $44 and Inventory is $25. Note that our Balance Sheet from now on will separate raw materials and finished goods. You should have $12 in raw materials and $13 in Finished Goods, and $25 in Total Inventory.

You can see now that the Cost of Production labor is "tied up" in inventory. That $1 cost cannot be recognized (or expensed) until the Inventory is sold. That's one reason companies closely manage inventory quantities and always want to sell it quickly.

So, let's get selling!

It's a hot day and you're sweating, but it's OK because sales are very, very good. Your new location pays off, and easily earns back what you spent renting it. Kids from other neighborhoods—total strangers!—come by on their bikes, having heard about your great lemonade.

Some friends come by, with their tongues practically dragging on the pavement. "Please, please, give us some lemonade!"

"Give?" you repeat.

"We left our money at home," they explain. "But we're good for it, we promise!"

Since they're friends, you let them buy their lemonade on credit.

By the end of the afternoon, your arm is about to fall off from pouring so much lemonade. But it's all worth it when you total up your sales.

60 glasses for 50 cents each

40 glasses cash and 20 glasses on account

What's your total sales? Thirty dollars. Twenty dollars Cash. Ten dollars on Account.

Let's review what happened here.

Did you sell all the lemonade you made up? Yes.

How many glasses did you sell? Sixty.

What goes out of the business? Inventory.

How much? Thirteen dollars.

What comes in? Cash.

Cash for how much? Twenty dollars.

So we get $20 for the forty glasses we sold for Cash. What else happened?

Some of your friends said they wanted to buy some lemonade, but they didn't have any money. Their parents hadn't given them what? Their allowance. So, they wanted to buy now, and pay when? Later. Did you, ever kind and wonderful and always on the outlook to increase sales, decide to sell to them? Yes. Admit it, did it make you a little nervous. A bit. Sure. Did you make a record of the sale? Yes.

Sure, the kids on credit are your friends and all—but this is business! You got out your little notebook and recorded these sales... Ted, 1 glass,.50, Natalie, 2 glasses, 1.00...etc.

What did your friends do? They set up an account with whom?

Right, with you!

Did those thirsty kids get the lemonade? Sure did.

Was it a sale? Yes!

You just didn't receive any…what? Cash.

So, you had to set up an account.

Is this money owed to you right now? Yes!

Pretty soon, though, you'll want to go out and receive what? The green stuff. Cash.

So, if you have to set up an account and plan to receive the cash from your friends, the account is called what? Accounts Receivable. Is an Account Receivable something we have? Yes.

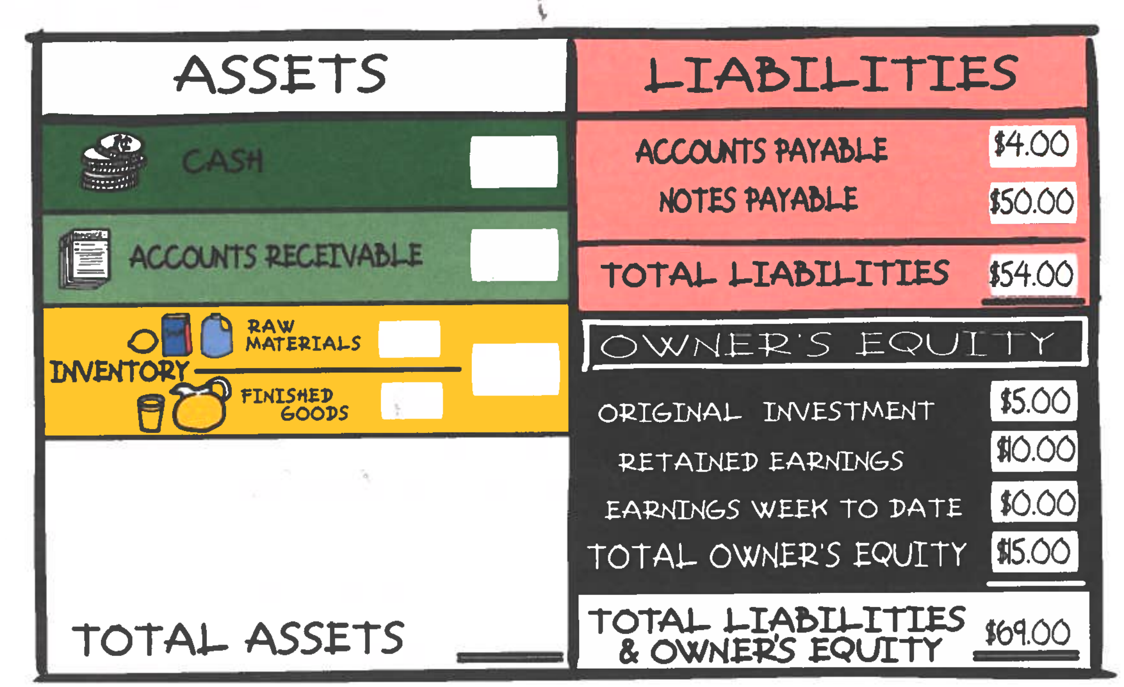
That means it's a what? An asset. Since it's money we are going to get soon, is it almost cash? Yes. What color should we make it? Almost green.

Did your friends promise, promise, promise to pay you? Yes. And even did a pinkie swear! They said they were good for it. (And if you can't trust your friends, who can you?) But, honestly, have they paid you yet? No, not yet, but they better!

They said they were going to get their allowance at the end of the week? Yes. Right before they chugged down the lemonade.

Was this a good idea? Why do businesses let people set up accounts? Ever hear of "buy now, pay later"? Right, to generate more sales!

Bring the next scorecard up to date, to show the changes in assets.



So are we in balance? No.

What do we need to show?

We need to record our profit or earnings for the week.

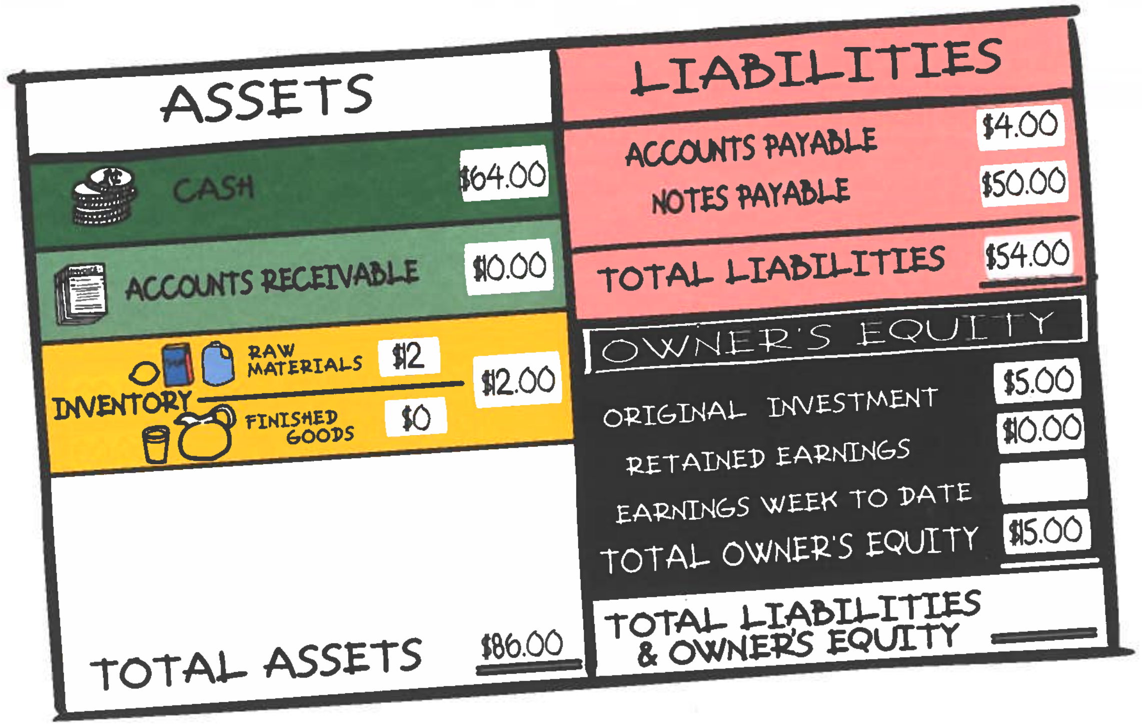
So how much did we have in total sales? $30.

We had $20 in cash and $10 on account.

How much did it cost us in lemonade? $13.00

So if it cost us $13.00 and we sold it for $30.00, what's our profit or earnings for this sale? $17.00

Record your profit or earnings below.



Are we in balance? Yes.

Good job! Congratulate yourselves! Give yourself a high five! Put on a great CD or turn on your mp3 player and dance to the music!

Unfortunately, in business as in life, there are good times and bad times. No sooner are you dancing around your room than the phone rings.

It's a friend of yours telling you that one of your other friends, Johnny, the incredibly thirsty one who bought eight glasses on account has—gasp!—moved away!

After throwing yourself to the ground and stamping the floor with your fists and crying, you conclude that this moved-away, no-good friend is unlikely to pay his debt. Given this sobering realization, you also conclude that this act of treachery will have a negative impact on your business and your financial records. Are this eight glasses a loss? Of course! What do you call this kind of loss? Bad Debt. This Bad Debt expense = $4.00

Now what are we going to do?

Even as you regain control, you still can't believe it! That kid promised to pay you! He even gave a pinkie swear, which is like the highest oath a kid can take! You figured he was good for it. But now he's left town. Oh, well, at least he didn't leave town thirsty—thanks to you!

Do we have to recognize the loss? Yes. We had $10.00 in Accounts Receivable, four of which belonged to that totally rude and worthless weasel cheater and all-around bad kid who you were once foolish enough to trust and call your friend. He'll probably end up in prison, or politics—or both!

So what are we going to do? You list your options.

Send out the collection agency.

Hire a hitman.

Hire a lawyer.

Tell your parents.

Get your big brother or sister to beat him up.

Put a spell on him so he stays short his whole life.

E-mail the President to call out the National Guard.

But you're a business person, remember? So what do we do to recognize a bad debt?

Reduce Accounts Receivable? Sadly, yes.

Reduce it by how much? Four whole dollars.

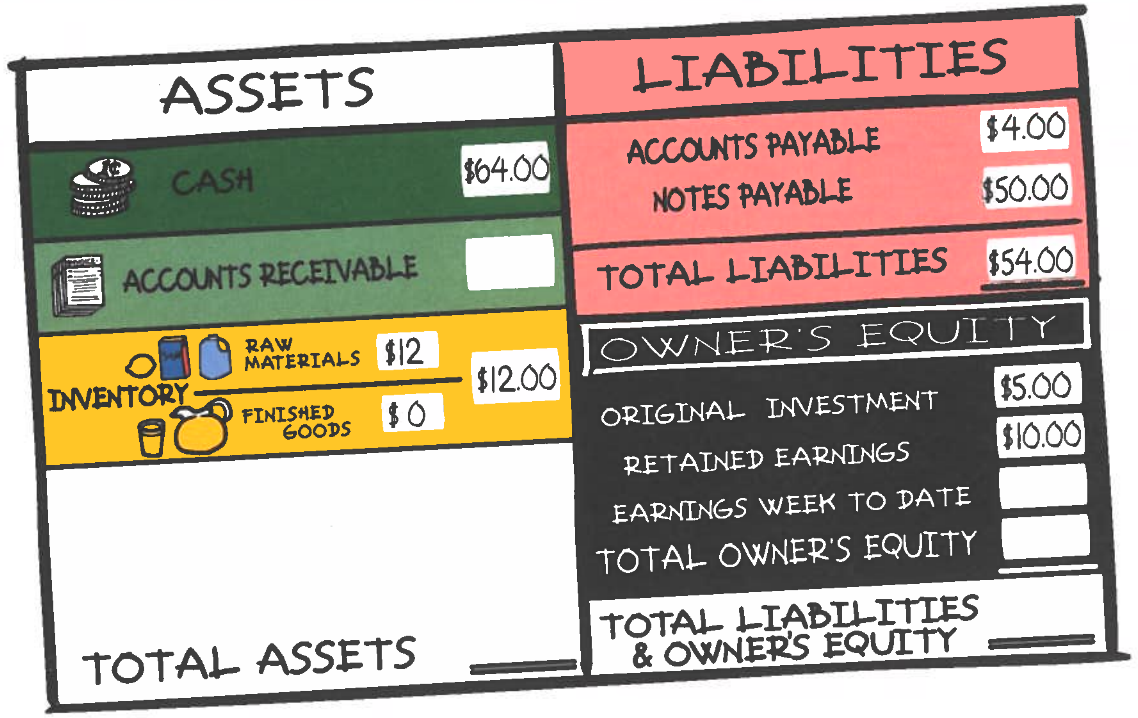
Are we in balance now? No.

Is the Bad Debt a cost of doing business? Yes.

And a cost of doing business is called what? An expense.

And expenses always reduce what? Earnings.

So, reduce earnings by $4.00 to reflect the bad debt expense.



Now, are we in balance? Yes.

On which financial statement are we going to record the Bad Debt expense? Right, we'd write it on the Income Statement. For how much? $4.00 (Expenses).

Take a moment and catch your breath.

Sobered by the experience of the bad debt, you decide to repay $25.00 of the bank loan. We want a good relationship with our banker. You hope you'll never be labeled a "bad debt." So, you take $25.00 out of our cigar box.

You bike to the bank and find the loan officer you dealt with before. "Here's $25.00 on the loan," you say. "I did really good selling lemonade and I want to pay you back. Thanks a lot!"

The bank seems pleased as you hand over the money. But something tells you that the banker isn't done yet.

"Is there something else?" you ask.

"How about the interest?" replies the banker.

"Oh, yeah," you say. "Mom and Dad said something about that. I remember when I repaid the money I borrowed from my Mom and Dad they wanted a hug," you add. "Do you want a hug, too? Is that interest?"

The banker doesn't want a hug. What the banker wants is real interest.

"Interest?" you say. "Boy, how much interest?"

"Two dollars," the banker says.

"Two dollars?! My parents just wanted a hug, they didn't charge any interest. But you want interest instead?"

The banker nods very slowly.

"Okay," you sigh, reaching into your pocket for the two dollars. "I'll pay the interest. This must be the real world. Well, thanks for taking an interest in my business."

So, what goes out in cash? $27.00

On the right side, let's take $27.00 out of the Notes Payable! No!

Why not?

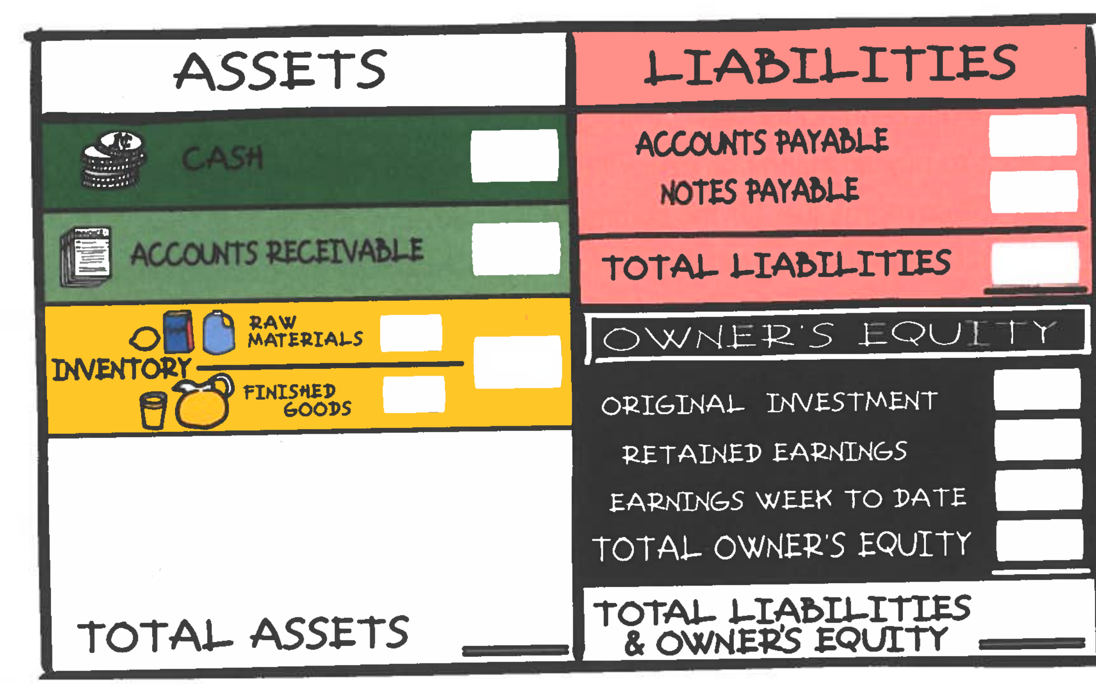
Because $25 is for the principal on the Note and $2 is for what? Interest expense.

What do you have to reduce by $2 on the right side, to account for the interest expense. $2 off Earnings Week to Date.

So, the interest is a cost of doing business with whom? The bank.

And a cost of doing business is an expense which reduces what? Earnings.

Show these transactions on the next scorecard.



So, hey! We had to pay out some extra money to do business with the bank.

What part of this transaction shows up on our Income Statement? The Interest Expense for $2.

The interest expense shows up on the Income Statement. But not borrowing the cash or paying back the principal of the loan. It's the extra money or the cost of doing business with the bank—that expense shows up on our Income Statement.

This is important, and worth repeating. Interest expense shows up on the Income Statement as an expense.

You get another lesson about the real world when your neighbors, the ones renting you space on their lawn, become concerned with all the kids and their bikes and skateboards and roller blades around on their sidewalk and front lawn. They asked you to talk with your parents about buying an insurance policy.

Your parents agree that an insurance policy is a good idea. They agree to drive you to their insurance agent's office.

You enter the All-Safe Farm Insurance office. The agent greets you and gives you a desk calendar before you even sit down. It has large color pictures of things like red barns, mountains, forests in autumn, and kittens. It's not exactly to your taste, but, remembering your manners, you thank the agent. Secretly, though, you plan on giving it to your friend's little sister to cut up.

"Now, what can I do for you?" the agent asks.

"I want to buy an insurance policy for my lemonade business," you say. "I need one that will cover me just for the summer. Can I buy one just for this year?"

The agent says it's best to buy one for three years. In fact, he adds, he only has a three-year policy which costs $3 payable in advance.

"You mean I have to pay now, in advance, for three years?" you say. "But I only want one for this year because who knows what I'll be doing next year. How much is it anyway?"

"Three dollars," the agent tells you.

"Boy," you say, "that seems like a lot to have to buy one in advance for three years..."

The agent insists it's the only way to go.

"Okay," you sigh, reaching into your pocket for three dollars. "Here's the $3 for the policy and be sure to come by the lemonade stand. After all, I gave you some business. It's only fair that you give me some, too!"

So you give the agent how much? $3.00.

And you get what? An insurance policy.

An insurance policy especially designed just for lemonade stands. And don't forget that free, attractive desk calendar!

And this policy is going to cover you for how many years? Three years.

So now you have got this policy? Does it have value? Yes.

You have it now, right? It's something you now have for your business. So, where does it show up? On the Balance Sheet.

Where? On the Asset side.

What goes out? Cash.

How much? $3.00.

And what comes in? An insurance policy.

Did we pay for it in advance? Yes.

For how many years? Three.

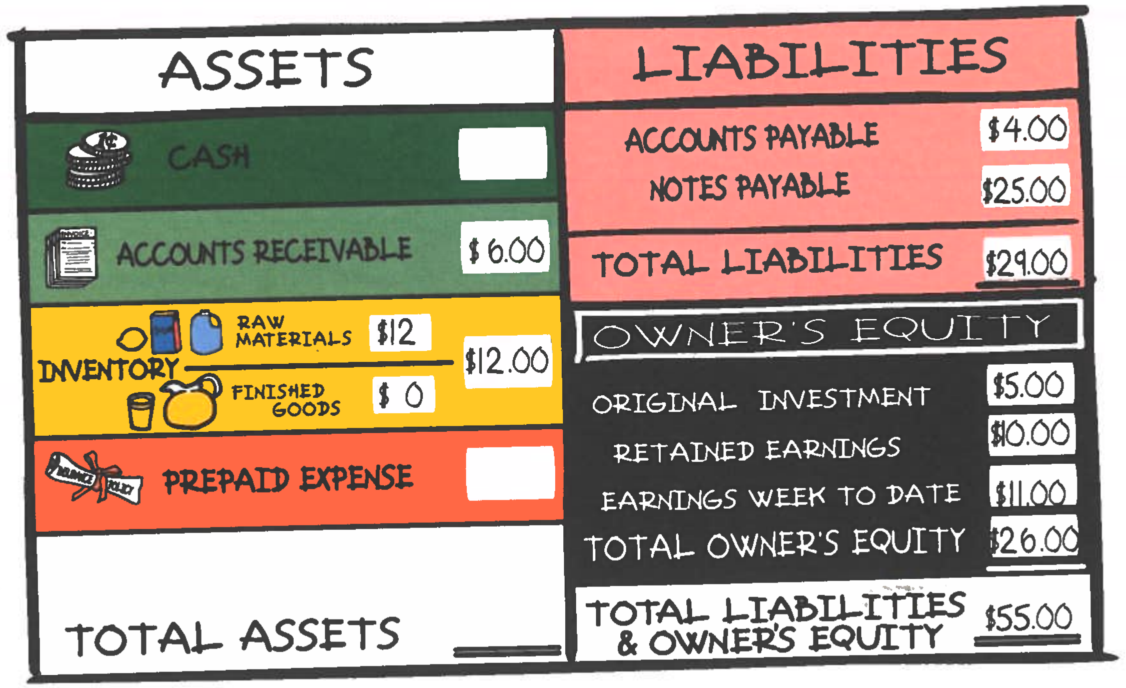
How much per year? One dollar.

It's an expense then, that you paid in advance. So, what should we call this item? How about PREPAID EXPENSE.

For how much? $3.00.

Now we have a Prepaid Expense, the insurance, for $3.00.

Please record these transactions.



Each time we've talked about expenses, we've said they reduce earnings. What makes an expense an Asset? When we pay in advance and it has value INTO future accounting periods.

This is a special policy designed just for lemonade stands. What's going to happen to the first year when we buy this policy? Right, it's going to get used up!

So how do we reflect that on our scorecards?

The first year is a Current Expense.

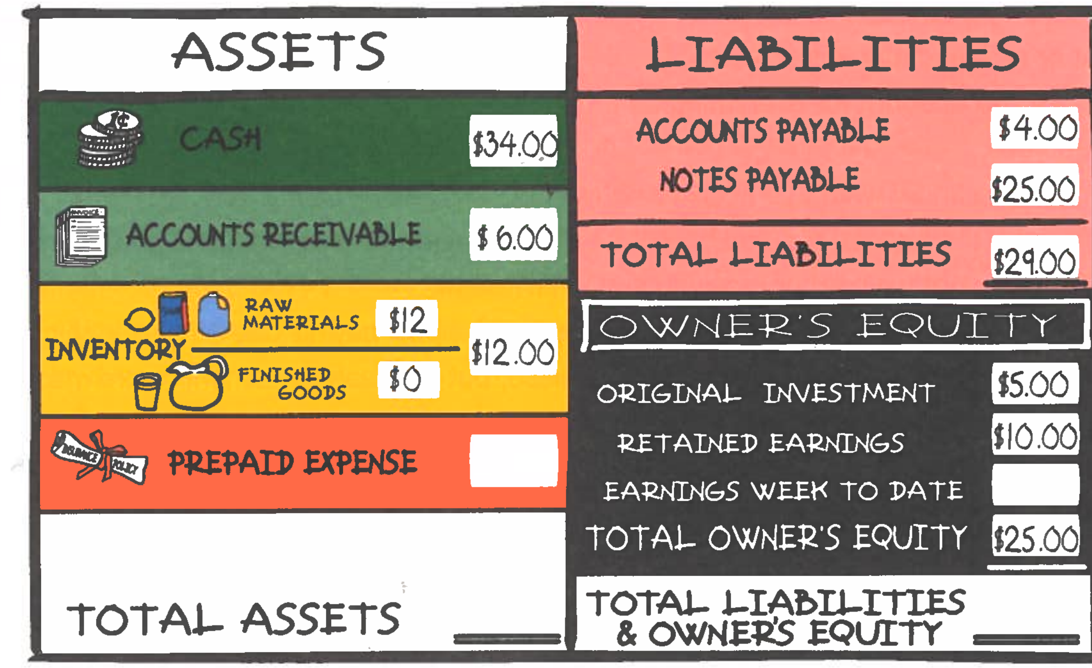
So what do we do? Take one dollar off the Prepaid Expense.

Subtract ONE dollar from the prepaid expense. This year's insurance gets used up. So a dollar goes out.

Are we in balance now? No!

So, what needs to happen on the right side of the board? We take a dollar out of Earnings Week to Date.

Enter these transactions below.



Why do we take $1.00 out of earnings? Because it's a current expense.

We paid three dollars for how many years? Three years.

For how much per year? One dollar per year.

If we go back to the agency and say we've decided to get out of the lemonade business, our insurance agent's going to give us back how much? $2.00. So a Prepaid Expense has value and is an Asset.

The policy right now is worth how much? $2.00. Right!

For which years? Year 2 + year 3.

Have we used those years yet? No.

And the ONE dollar we're taking when? Now. As a current expense.

What happens next year? Another dollar goes out.

And the next year? Still another dollar goes out.

In truth, we've taken some liberties in how we did this. Would we expense the whole first year's expense of $1 all at once? No. Since we're operating on a weekly basis, we'd take how much each week? 1/52. Right! But we're not going to mess with change at the moment, so we're going to take the whole first year's expense all at once, even though you'd expense in reality a little bit each month, or each week.

Okay. Now, for the last few pages, we've been using a very, very, very specific method of accounting.

We've been accounting for everything as it happens, whether or not we've paid out or received any what? Cash.

So, we account for everything as it happens—or, as accountants would say, as it accrues.

Do you know what this accounting method is called? The ACCRUAL METHOD.

Right, the Accrual Method. We've been accounting for everything as it happens, whether or not we paid or received any what? Cash.

The Accrual Method started when people stopped paying cash for everything. Business promises and agreements took place, but the cash settlements were made at a later date. The Accrual Method of accounting creates an accurate measure of a company's financial position even though the cash has not been settled.

Let's look at this a little closer.

Did you receive any cash for our accounts receivable? No.

Did you sell the lemonade to your friends? Yes.

Are we accounting for it as a sale? Yes.

At this point in time does it have value? Yes.

Did you earn this money? Yes.

You just didn't receive any…what? Cash.

So, on the Accrual Method, sales are recognized not as the money is received but when it is what? Earned.

How about the inventory?

Did we get the sugar? Yes.

Did we pay cash for it? No.

But we did what? Charged it–put it on account.

Did this purchase happen? Yes.

Do you owe Pappy Parker, the grocer? Yes.

Did we record that you owe it? Yes.

So, on the Accrual Method, we account for purchases when they happen or when we owe them, not when we pay for them.

Let's look at the Prepaid Expense.

How much did the insurance policy cost? $3.00 in cash.

Did we use up all $3.00 worth of insurance this year? No.

How much of the insurance happens this year or how much did we actually use this year? $1.00.

Right, we only used $1.00 of the insurance. So we account for the insurance as it happens or as we use it.

So, in the Accrual Method of accounting, we account for everything when we…Earn it.

Or when we…Owe it.

Or when we…Use it.

So, you're accounting for everything as it accrues or as it happens.

This accounting method is called what? The Accrual Method.

And on the accrual method you account for everything when? When it happens. Whether or not you've paid or received any…Cash.

One more time, on the Accrual Method you account on transaction when…? You earn it, owe it, or use it.

Great! Let's take a snapshot of our scorecard—and, while we're at it, a motion picture clip, too. It's the end of your second week in the lemonade business.

Here is a reprint of your final Balance Sheet.

ASSETS		LIABILITIES	
CASH	$34.00	ACCOUNTS PAYABLE	$4.00
ACCOUNTS RECEIVABLE	$6.00	NOTES PAYABLE	$25.00
INVENTORY: RAW MATERIALS $12; FINISHED GOODS $0	$12.00	TOTAL LIABILITIES	$29.00
PREPAID EXPENSE	$2.00	OWNER'S EQUITY	
		ORIGINAL INVESTMENT	$5.00
		RETAINED EARNINGS	$10.00
		EARNINGS WEEK TO DATE	$10.00
		TOTAL OWNER'S EQUITY	$25.00
TOTAL ASSETS	$54.00	TOTAL LIABILITIES & OWNER'S EQUITY	$54.00

Now, using the Accrual Method of accounting, you're going to fill out your own Income Statement on page 63. But first you need more information.

And, to put it all in one place, here's information about this week's purchases, sales and expenses that you'll need to complete the income statement.

1. After a successful first week in the lemonade biz you decide to go to the bank. You show the banker your financial statements and the bank loans you $50.00 Cash.
2. You decide to give yourself an afternoon off, and sell your remaining inventory to your best friend $2.00 at cost, for Cash. Your sale, at cost = $2.00.
3. With your Inventory reduced to zero, you purchase 10 lbs. of sugar @ 40¢/lb., and charge it to the grocer on account for $4.00.
4. You purchase 100 lemons @ 20¢/lemon, paying cash $20.00.
5. You make up one batch of lemonade (50 lemons + 5 lbs. of sugar = 60 glasses). You also pay $1.00 labor to make the lemonade. Cost of Production = $13.00.
6. Sales are good. You sell all 60 glasses for 50¢ each, 40 glasses Cash and 20 glasses on account. Your Sales = $30.00, $20.00 Cash, and $10.00 in Accounts Receivable.
7. One customer who had bought 8 glasses moves away from town. You conclude that he's unlikely to pay his debt. Bad Debt Expense = $4.00.
8. You repay $25.00 of the bank loan, plus $2.00 for interest expense.
9. You pay $3.00 for a 3-year liability insurance policy. Reflect this year's insurance expense for $1.00.

Go line by line from 1 to 9, looking for these three things:

Is it a Sale?

Is it a Purchase? OR

Is it an Expense?

Your decision should help you complete the Income Statement.

There is one item that you need to fill out on your Income Statement that you won't find on the balance sheet and you won't find it in the list of transactions we just went through. Do you know what it is?...Beginning Inventory.

Now, this latest Balance Sheet is for which week? Right, week number 2.

It's not a Beginning Balance Sheet, it's a what? Ending Balance Sheet! Good.

The inventory we have left at the end of this second week is...? Ending Inventory.

Let's look at this for a moment because it's important.

We finished week two with how much ending inventory? Twelve dollars.

So we know that the Beginning Inventory for week three will be how much? Right, $12. Because the Ending Inventory always becomes the Beginning Inventory next week.

Is the Beginning Inventory for week two handy? Where could you find it? The Ending Balance Sheet from week one.

Here is week one's Ending Balance sheet for easy reference:

WEEK ONE-ENDING BALANCE SHEET

ASSETS		LIABILITIES	
CASH	$13.00	NOTES PAYABLE	$0.00
INVENTORY	$2.00	TOTAL LIABILITIES	$0.00
		OWNER'S EQUITY	
		ORIGINAL INVESTMENT	$5.00
		RETAINED EARNINGS	$10.00
		EARNINGS WEEK TO DATE	$0.00
		TOTAL OWNER'S EQUITY	$15.00
TOTAL ASSETS	$15.00	TOTAL LIABILITIES & OWNER'S EQUITY	$15.00

What was the Beginning Inventory for week number two? Two dollars.

And where did you go to find the $2? On last week's Ending Balance Sheet. The Ending Inventory.

So, you always go to the Ending Balance Sheet from the last week to find your Beginning Inventory for this week.

One more time. The ending inventory automatically becomes what? The Beginning Inventory for the Next Week.

Good. Now we're wrapping up our second week. Where do you find your Ending Inventory for week two? On week two's Ending Balance Sheet.

Okay. Good. Here's that ending balance sheet.

WEEK TWO-ENDING BALANCE SHEET

ASSETS		LIABILITIES	
CASH	$34.00	ACCOUNTS PAYABLE	$4.00
ACCOUNTS RECEIVABLE	$6.00	NOTES PAYABLE	$25.00
INVENTORY: RAW MATERIALS $12; FINISHED GOODS $0	$12.00	TOTAL LIABILITIES	$29.00
PREPAID EXPENSE	$2.00	OWNER'S EQUITY	
		ORIGINAL INVESTMENT	$5.00
		RETAINED EARNINGS	$10.00
		EARNINGS WEEK TO DATE	$10.00
		TOTAL OWNER'S EQUITY	$25.00
TOTAL ASSETS	$54.00	TOTAL LIABILITIES & OWNER'S EQUITY	$54.00

Let's quickly review the balance sheet

Assets equal? Assets = $54.00.

Liabilities + Owner's Equity equal? Liabilities + Owner's Equity = $54.00.

Does the left side equal the right side? Yes.

The left side always, always equals what? The right side.

Good job!

Now, please complete the Income Statement. And do you remember what numbers should match on the Balance Sheet and Income Statement? Net Profit should equal Earnings Week to Date. So, we know that Net Profit should end up at $10—or you've made a mistake.

ACCRUAL INCOME STATEMENT

INCOME STATEMENT	Begin: Monday A.M. End: Sunday P.M.		
SALES			$
Beginning Inventory	$		
+ Purchases			
+ Labor			
Total Available for Sale		$	
- Ending Inventory			
= COST OF GOODS SOLD			
GROSS PROFIT =			
EXPENSES			
•			
•			
•			
= TOTAL EXPENSES			
NET PROFIT BEFORE TAXES			
INCOME TAXES			
NET PROFIT AFTER TAXES			$

What were your total sales? Total Sales = $32.00

By chance, did you first have $30.00 for total sales. If so, where did the other two dollars come from? Yes, the sale to your friend at cost.

We're going to point out all the cash and non-cash items to help you better understand the Accrual Method.

To review, then:

First, we had the $2 sale. Was it Cash? Yes.

Then we had the $30 sale. How much was Cash? Twenty dollars.

And the ten dollars was what? On Account.

The Beginning Inventory was what? $2.00.

Was that Cash? No. It was lemonade.

How about purchases? $24.00

How much was cash? $20.00

And the $4 was what? Accounts Payable.

And the labor was how much? $1.00

Was it paid for with cash? Yes.

So the total available Beginning Inventory + Purchases + Labor is what? $27.00

And did we use all the Inventory? No.

What was our ending Inventory? $12.00

If we subtract that from the total available, what are the Costs of Goods Sold? $15.00

We sold the $15 worth of goods for $32 which left us how much in Gross Profit? $17.00

What were the expenses this week? Bad debt, Interest, Insurance.

The Bad Debt was what? $4.00

Did you pay Cash for that?No.

Interest was how much? $2.00.

And did we pay Cash for that? Yes.

Finally, the insurance was what? Only $1 because we are using which method of accounting? The Accrual Method.

But, did we pay Cash? Yes.

So the total expenses are? $7.00.

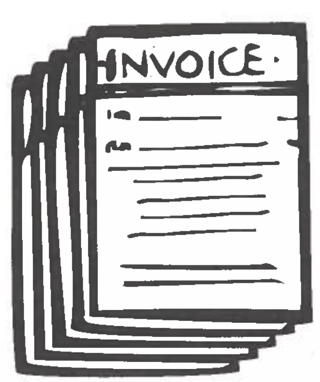
With a Gross Profit of $17 and $7 in expenses, what is the bottom line? $10.00.

And does this match our earnings on the Balance Sheet? Yes.

If you got $10 on the Income Statement (Net Profit) and $10 on the balance sheet (Earnings Week to Date), please give yourself a gold star!

Now, say you were just handed an Income Statement on a computer printout and you saw this 32.00 in Sales with a dollar sign next to it, your linear left brain would probably think that these total sales of $32 were all what? Cash!

But is this $32.00 all cash? No.



Some of it's what? Receivables.

But we're accounting for it as $32.00 worth of what? Sales.

But is it all cash? No.

It's cash and other things. So, it's cash and non-cash values.

And unless you went back to your sales journal and figured out what your receivables and cash sales were, you'd have no way of knowing what part of the total sales of $32.00 was Cash and what part was the Accounts Receivable.

If you just look at the $32.00, you wouldn't know what part was Cash and what part was non-cash sales.

Now, let's look at Beginning Inventory. Is inventory Cash? No.

So we had $2 worth of lemonade here.

We know we paid cash for some of our purchases and we know we charged some of our purchases. How much did we pay cash for? $20.00 And we charged…? $4.00. But when you look at this $24.00 in purchases your left brain might think again, that you paid for everything with all what? Cash.

But did you? No.

Next, you paid $1.00 cash for labor. If you look at the $15 Cost of Goods Sold, would you even know what part of that you paid cash for? And what you charged? Forget it! I can barely remember what I ate for dinner last night!

Besides, this Cost of Goods Sold…that relates only to what? Lemonade.

So, $15 in COGS is the cost of the lemons, sugar and labor that went into making up the lemonade that you sold.

And $15 from $32 gives us a Gross Profit of $17.

Now, let's look at these expenses.

Which one did we not pay cash for? Bad Debt.

So, that's not cash. We did pay cash for what? Interest and Insurance.

(By the way, you don't expense glass rental, rent, and advertising for week two because they happened last week.)

So, when we look at the $7 in total expenses; if you were looking at a financial statement and you saw $7.00 in total expenses your linear left brain again wouldn't know any better and would think you'd paid for all of these expenses with what? Cash.

But did you? No way. So, this $7 is again a mixture of Cash and non-cash expenses.

The point is, on the Accrual Method, in order to understand this method this financial statement here is treated as a "Not-Only-Cash" Income Statement. Because it has Cash and non-cash things all mixed in together. Do you know what happened in Cash here and what didn't? Not unless we have an extraordinary memory and write everything down.

You have to treat this as a "non-cash-statement" or a not-only-cash statement. By the way, this is not accounting jargon, but it's a lay person's way of remembering the Accrual Method.

Now let's look back at our Balance Sheet. Are all our Assets Cash? No. Most of the Assets are what? Non-cash things like our Accounts Receivable, Inventory, and prepaid expense.

Our total Assets are what? $54.00, and a mixture of Cash + non-cash values.

But our linear left brain might look at this $54 in total Assets and again think it was all what? Cash.

But is it? It's Cash and everything else.

So, on the Accrual Method we account for everything when it happens, whether or not we've paid or received any cash. Since it's a mixture of cash and non-cash, we call it a what?

A Not-Only-Cash method. So, there's cash and non-cash values mixed in on the accrual method.

You've probably heard the statement, "They are using creative accounting." You may think this means someone is doing something shady or illegal—but there are legitimate and legal forms of "creative accounting," and we're going to look at one now.

The Accrual Method is not the only method of keeping track of earnings. Can you guess what the other method is called? The Cash Method.

Now, let's go back and look at week number 2 using the Cash Method and we're going to need to see things very differently. We can then compare the Cash and Accrual Methods.

Some of you may want a physical way of remembering things. If so, get your finger and tie a green string (green for Cash) around it to guarantee that you will remember this forever. Repeat the following.

Cash is Cash is Cash!

Now, switch to your other hand and tie a green string around your finger and repeat again:

Cash is Cash is Cash!

So on the Cash Method you would account for things ONLY when they happen in what? Cash.

So, only events happening in cash are accounted for on the Cash Method. Remember that in the accrual method, everything is accounted for as it is earned, owed, and used.

On the Cash Method, you account for things when you receive what? Cash. And when you pay what? Cash.

The Cash Method, obviously, is very different from the Accrual Method where you Account for a transaction regardless of whether you paid or received cash. You can expect that the results will be different.

Okay. We've been on what kind of method the whole day? Accrual.

But now, we are only going to do a Cash Income Statement to show the contrast of the Cash and Accrual Methods. You will need to look back at the Accrual Method Income Statement on page 65 as you complete the Cash Method Income Statement below.

CASH INCOME STATEMENT	Begin: Monday A.M. End: Sunday P.M.		
SALES			$
Beginning Inventory	$		
+ Purchases			
+ Labor			
Total available for sale		$	
- Ending Inventory			
= COST OF GOODS SOLD			
GROSS PROFIT =			
EXPENSES			
•			
•			
= TOTAL EXPENSES			
NET PROFIT (Gross Profit - Expenses)			$

Let's begin with sales. What would be the total sales on the cash method? $22.00 Total Sales.

Why is it only $22, instead of the $32 on the Accrual Method? The Accounts Receivable doesn't show up.

Moving down, is Beginning Inventory cash? No. So nothing will show up there.

How much did we have in cash purchases? $20.00.

And how much in cash for labor? $1.00.

What would our Cost of Goods sold be on the Cash Method? $21.00. Right!

So, whatever, we paid Cash for is our Cost of Goods Sold!

Which means, we don't even account for what? The sugar. Why? Because we charged it.

Let's look at why a company with inventory can't use the Cash Method.

At the end of every year, if we saw that we were going to make a profit and have to pay taxes, we could just run out and buy a lot of inventory and pay cash for it, and then take it all as COGS and reduce our profit so we wouldn't have to pay any taxes.

Do you think the government would like that? Since we have a business that sells inventory, do you think the government will allow us to report on the cash method? No way!

What kind of businesses can be on the Cash Method? Service business, like doctors, lawyers, accountants, seminar companies, consultants, real estate companies, cleaning services, etc.

What's the deciding factor? Inventory.

So, you mean to tell me that our lemonade stand can't report to the IRS using the Cash Method? Sorry it's the law.

What accounting method do we have to report on? Accrual.

Because we have what? Inventory.

So if you're delivering a service, the IRS says it's okay for you to be on which method? Cash.

And for those of us in manufacturing, retail, or wholesale with inventory for sale we must be on which method? Accrual.

For the sake of argument, what would happen next year if we could be on the Cash Method? On the Cash Method, we'll take $3 this year for our insurance expense.

Can we take any of the insurance next year as an expense? No. So what's going to happen? Our profit's going to go up.

So, for those service businesses that can be on the Cash Method, they take as many expenses now so they can pay less what? Taxes, right!

When will it catch up with them? Next year.

They weren't getting out of paying taxes, just what? Delaying.

Have you ever heard the saying "a tax deferred is a tax reduced"? The theory is you're going to defer taxes this year and when you do have to pay them, you'll pay for them with what kind of dollars? Cheaper or inflated. And who gets to use the money you saved by deferring taxes? You do!

So that's the game. If you're a manufacturer, can you do this? No.

What method is the most accurate reflection of reality and profitability? Accrual.

What method are we running your lemonade business on? Accrual.

Can a service company keep both sets of books?

It's not accounted for because we charged it; we didn't pay what? Cash.

So if sales are $22 and COGS is $21, what is the Gross Profit? $1.00. WOW! All that hard work for one measly buck! No wonder some really lucky kids get their parents to send them to camp!

Let's look at Expenses:

Does the Bad Debt show up? No.

Because it's not what? Cash.

How about interest? Yes, $2.00, because you paid out cash for that.

How about the insurance? Yes. Okay, but $1.00 or $3.00?

How much did you pay out in Cash? $3.00.

So, yes, you can expense all $3 this year? Wow! Because you paid for it, with what? Cash.

So, we're going to take the whole $3 for all three years this year. We paid for it with cash in advance, so we're going to take all three years worth of expense now.

Total Expenses are $5. If Gross Profit is one dollar and Expenses are $5, what's the Net Profit. $-4.00. Yikes! This is going from bad to worse!

Let's look at these two Income Statements.

We used two methods. Did we get different results? Yes! The Accrual Method +$10 in Earnings and the cash Method was -$4.

So, you can see that businesses have an opportunity here to be creative in how they account for things. Which method would you want to use? Accrual.

Accrual, why? It looks better–to take to the bank or investors–because it has more profit.

For what other reason would you use the Accrual Method? It's more accurate–everything that happened is accounted for.

Why use the Cash Method? For tax purposes.

Oh, with minus $4 in earnings, will you owe any taxes? No. In fact, you might get some refund.

Can you use the Cash Method in our lemonade business? Good question!

Well, some businesses can use the Cash Method and some cannot. There is one item on the Balance Sheet that determines whether or not you can use the Cash Method.

What is it? Inventory.

Yes, any business with inventory must use only which method? Accrual.

Does the lemonade stand have inventory? Yes. So which method do we have to use? Accrual.

Guess what? In the service business, we can report to the government on the Cash Method, and keep our books on the Accrual Method to show the banks or investors. Sounds like two sets of books...pretty shady! Can we have two sets of books? Yes. It's called "Creative Accounting."

Guess what happens at the end of the year? We give our books to our accountant and what does our accountant do? Turns it into the Cash Method for whom? For the IRS.

A lot of businesses run the business on the Accrual basis and submit to the government on the Cash basis for tax purposes.

Can you switch methods? Be very creative? The government will always allow a business to switch from the Cash to the Accrual Method (they will most likely collect more taxes), but you cannot switch the other way. So if you start a service company and want to use the Cash Method, you need to elect that method the first year.

What about service companies that have some inventory they sell? Like a seminar company that sells books?

This can get into a gray area where there is disagreement between the business owner and the IRS. The IRS will ask, "Is the inventory material to the generation of profit to the business?" If the answer is "yes," then you have to use the Accrual Method. If "no," you can use the Cash Method. The gray area is how much is "material to generating profit" and most businesses would consult its Certified Public Accountant (CPA) on this issue, but it doesn't take much.

Before closing this chapter, let's review it.

On the Accrual Method you account for things when? When they happen.

When you earn it and when you...what? Owe it.

Or when you? Use it.

Whether or not you've paid or received any what? Cash.

And on the Cash Method, cash is cash is cash.

And you only account for things when they happen in cash or when you what? Pay it or receive it.

PHEW!

You're doing great! Take a break before we move on the next bit of business!