

## 5.1: Using a chart of accounts.

### Learning Objectives

After completing this section, students will be able to:

- Relate accounts to the financial statements
- Describe how a chart of accounts is used
- Identify how accounts relate back to the earlier discussion of accounting elements

*Question: How do companies know what items or amounts to put on the financial statements we learned about earlier?*

Earlier we learned the accounting equation, specifically:

### Assets = Liabilities + Equity

and we learned that these items are reported on the balance sheet. We learned that Revenues – Expenses +/- Gains/Losses = Net Income which then increases equity. Other changes in equity were shown on the statement of equity or changes in retained earnings. The examples we looked at and worked with seemed to have amounts associated with each asset or liability. Those amounts were determined by looking at each account and by what amount it changes due to business events at the company. This means if a company wants to report amounts for individual assets, liabilities, revenues and expenses, it must first have an **account** to track the increases or decreases to that item. A chart of accounts is simply a list of all the items – assets, liabilities, equity, revenue, expense, gain or loss – that the company wants to track separately. It might look like this:

Chart of Accounts			
Number	Description	Account Type	Financial Statement
1-001	Cash	Asset	Balance Sheet
1-010	Accounts Receivable	Asset	Balance Sheet
1-020	Prepaid Expenses	Asset	Balance Sheet
1-030	Inventory	Asset	Balance Sheet
1-040	Fixed Assets	Asset	Balance Sheet
1-050	Accumulated Depreciation	Asset	Balance Sheet
1-060	Other Assets	Asset	Balance Sheet
2-001	Accounts Payable	Liability	Balance Sheet
2-010	Accrued Liabilities	Liability	Balance Sheet
2-020	Taxes Payable	Liability	Balance Sheet
2-030	Payroll Payable	Liability	Balance Sheet
2-040	Notes Payable	Liability	Balance Sheet
3-001	Common Stock	Equity	Balance Sheet
3-010	Retained Earnings	Equity	Balance Sheet
3-020	Additional Paid in Capital	Equity	Balance Sheet
4-001	Revenue	Revenue	Income Statement
4-010	Sales returns and allowances	Revenue	Income Statement
5-001	Cost of Goods Sold	Expense	Income Statement
5-010	Advertising Expense	Expense	Income Statement
5-020	Bank Fees	Expense	Income Statement
5-030	Depreciation Expense	Expense	Income Statement
5-040	Payroll Tax Expense	Expense	Income Statement
5-050	Rent Expense	Expense	Income Statement
5-060	Supplies Expense	Expense	Income Statement
5-070	Utilities Expense	Expense	Income Statement
5-080	Wages Expense	Expense	Income Statement
6-001	Other Expenses	Other	Income Statement

The minimum accounts needed are 1 for assets, 1 for liabilities, 1 for equity, 1 for revenues, 1 for expenses, but we probably want to track a lot more detail like is shown in the sample. The key is to determine how many different assets or expenses you want to be able to track information about. If you do not list it on the chart of accounts then it will be difficult to be able to track the amount of that particular item and report it on the financial statements.

*Questions: So should there be a whole bunch of accounts and is there a limit to the number of accounts? What if I think of an account after we start our accounting?*

The number of accounts on the chart of accounts is up to each individual company and depends on the information it wants to use and communicate to investors. The FASB has not given as specific lists of accounts or what they may be called (there are some recommendations for submitting electronic files of financial statements). So referring to the list of assets on our sample above, a company that provides only services and does not buy and carry inventory could leave the inventory account off their chart of accounts. Another company may decide that fixed assets is not specific enough and would like to break it down and have a Trucks account separate from its Building account. They would list Trucks and then Building (two accounts) instead of Fixed Assets. Another company may lump all of the land, buildings and equipment into one account called Property or Fixed Assets like is shown in our sample. There are few rules and as accountants we would want to anticipate what we want our financial statements to look like (lots of detail and thus lots of accounts versus summarized with few accounts) and what that communicates to investors when we set up our chart of accounts.

Most computerized accounting systems have room for almost unlimited accounts and will allow for the addition of more accounts as you go through your financial year. However, thinking of things before we begin can make our life easier throughout the year.

*Question: Should new accounts just be added to the end of the list on the chart of accounts?*

One of the most important things to remember about an account and adding one to the chart of accounts is that each account needs to be identified as one of the accounting elements (asset, liability, revenue, etc.) and grouped with other accounts from that same element. Thus assets should be added and grouped with assets. So when part way through the year, when you for the first time have to hire and pay an attorney you may need to add an account. You may already have an account called professional services expense and you may just choose to use that. However if you want to see the legal costs separate from what you pay for engineering or other professionals, then you will need to add an account. You may even need more than one. If you are going to pay the attorney before they provide services then you will need an account called prepaid legal services (or something like that) and it will be listed with the other assets (prepaid means future benefit). If you are going to only pay the attorney as they provide the services or after they provide the services then you need a legal expense account to be grouped with the other expenses. An account can only be in one group (cannot be both asset and expense) so if you will pay the legal costs before the services are provided (asset) and then use those services such that they become an expense you will need two accounts (one for the asset and one for the expense). No moving accounts around – **we can move amounts but should not move accounts**.

### Key Takeaways

- What you want to communicate on the financial statements determines the length of the chart of accounts. Detailed financial statements mean long detailed charts of accounts while shorter, summarized financial statements can be developed from shorter charts of accounts.
- Each account must be associated with one and only one accounting element.

### Check yourself

#### Business event – purchase a delivery van for use in the business with cash

What would we look for on the chart of accounts? Since we know that the delivery van is an asset (future benefit) and cash is an asset, we will look in the asset section of our chart of accounts to find van (or vehicles or something similar) and cash. If they are not there or if we want the van separate from other vehicles or property then we would add that account and group it with long term assets. Cash would be an account under current assets.

#### Business event – borrow money from the bank

What would we look for on the chart of accounts? Since we are borrowing money and will need to pay it back then we know we have a liability. We can look in the liability section of the chart of accounts for note payable or loan payable and in the asset section for cash (that is what we are borrowing). If there is no account there or at least if we decide we want to track this loan

separately from other liabilities then we can add an account and group it with either long term or current liabilities depending on whether we are paying it back in less than one year (current) or in more than one year (long term).

*Question: How do accountants remember all of the accounts and what accounting element they are associated with?*

It is impossible to list let alone memorize all of the possible accounts. With millions of businesses in the United States and each of them having different assets, liabilities, revenues and expenses trying to list all the possibilities would be a waste of time. Accountants use lots of different accounts and account names and we do not want to get too concerned about the exact terminology. However, there are some principles about accounts you might use to help identify what accounting element is involved.

- The term **receivable** means we will receive cash in the future and thus a future benefit and an asset (examples: Accounts Receivable, Notes Receivable, Interest Receivable)
- The term **payable** means we owe cash in the future and thus it is a liability (examples: Accounts Payable, Loan Payable, Wages Payable)
- **Prepaid** means we have paid for something now that we will receive in the future and thus is an asset even when paired up with expense terminology (examples: Prepaid expenses, Prepaid Insurance, Prepaid Legal Services)
- **Unearned** means we have received cash now for something we will provide to a customer later – this means we owe the customer something so it is a liability even when it is paired up with revenue terminology (examples: Unearned revenues, unearned fees)
- **Accrued** means owed and thus will be used with accounts that belong with liabilities (examples: Accrued wages = Wages payable)
- The term **earned** is usually describing a revenue (examples: Fees Earned, Interest Earned)
- The term **deferred** means *wait for later* so it could be associated with either assets (payments received later) or some services provided later (deferred revenue = unearned revenue) so you will need to look for other clues on be more clear with the other words describing the account

You may want to download and complete the attached [Account Classification Worksheet.xlsx](#) as a review of what you should know about various accounts. Once completed it could serve as a reference going forward in using the accounts to track financial information.

### Key Takeaways

Terminology can be helpful in determining the account name and accounting element to group it with but it is not exact and may need clarification.

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