What Is A Chart Of Accounts? Definition Of Chart Of Accounts

Every time you record a business transaction whether it's a new bank loan or an invoice from one of your clients, you need to record it in the right account. But how do you know which account to record it in? That's where the chart of accounts comes in.

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A chart of accounts is a list of all your organization's accounts together in a single place. If the account is used to record transactions on the general ledger, it is on this list. It gives you an overview of every area of the business that spins or makes money. The main account types include revenue, expenses, assets, liabilities, and equity.

Companies in different types of business will have different looking charts of accounts. The chart of accounts for a major airline will have a significantly larger number of references to aircraft parts then your local pizza restaurant. Small businesses will likely not have as many accounts to keep track of, but will still find the COA a useful tool for quick overviews of their financial situation.

The chart of accounts needs to give anyone who is looking at it a decent idea of the nature of your business by listing all of the accounts involved in your organization's day-to-day operations. Generally speaking, the chart of accounts lists the account type with a brief description of the account, the account balance and identification code for the account. This information is generally represented in the order by which the accounts are represented on the company's financial statements.

> *The chart of accounts is important because it provides a map of your business and its financial parts. When a chart of accounts is well-designed, it separates out all of the organization's most important accounts and makes it easy to figure out which transactions get recorded where. It allows for better financial decisions, provides an accurate snapshot of the company's financial health, and makes it easier to follow financial reporting standards.*

Balance Sheet Accounts

Balance sheet accounts are named as such because they are necessary to create a balance sheet for the business. Balance sheets are one of the most commonly used financial statements. There are three kinds of balance sheet accounts.

Asset accounts record the resources your company owns that provides value. They can be physical assets such as land, cash, or equipment. They may also be intangible things such as software, patents, and trademarks. I said accounts cover both current assets or those that you can easily convert into cash and fixed assets or those that cannot easily be converted into cash or cash equivalents.

Liability accounts record all the debts your company owes. Liability accounts typically have the word payable in their name. Accounts payable, invoices payable, and wages payable, and payroll taxes are common examples. Unearned revenues represent another kind of liability account. These are usually cash payments that your company has received before the services are delivered.

You may also find contingent liabilities or those whose occurrence depends on a certain event. Contingent liabilities are basically potential liabilities in that they may or may not happen. For example, if a company faces a lawsuit, it may or may not be a liability depending on the outcome of the lawsuit.

Accounting standards say that a company needs to only record contingent liabilities if the liability is probable and if it's possible to reasonably estimate the amount. Examples of contingent liabilities include product warranties and lawsuits.

Equity accounts represent what's left of your business after you take away all of your company's liabilities from its assets. These accounts basically measure how valuable an organization is to its owner or shareholders. Owner's equity represents how much of the company the owner has, while shareholder's equity represents how much the shareholders have.

Income Statement Accounts

The income statement accounts are used to generate the other major kind of financial statement which is known as the income statement.

The income statement contains operating revenues, operating expenses, non-operating revenues and gains, and non-operating expenses and losses.

Revenue accounts display the income a company accrues during a specific period. This includes sales, interest income, and service Revenue. Discounts and deductions for returned merchandise are also included as part of the revenues.

Revenue can also be divided into operating revenue and non-operating revenue. Operating revenue refers to the sales the company makes from its core business, while non-operating revenue refers to the sale of the company makes from other secondary sources. Because non-operating revenues are typically not predictable or recurring, they are termed one-time gains or events.

How the balance sheet and income statement accounts interact with one another is complex but the general rule is this: Revenues increase your company's equity and asset accounts and expenses decrease your assets and equity.

Reference Numbers on the Chart of Accounts

Accounts in a standard chart of accounts are organized according to a numerical system. The numbering sets of the structure of accounts and assigns specific codes to your various general ledger accounts. The account number generally involves three components hear division code, the department code, and the account code.

The division code is usually a two-digit number and represents the specific division within a company. Because of this, it is only used in companies with multiple divisions. Single entity companies don't use this code. If the company is large and has a significant number of divisions, the code is expanded to a three-digit code to enable the inclusion of more than 99 subsidiaries.

The department code is also typically a two-digit code to represent the specific department within the business.

The account code is typically a three-digit code to describe the account itself. Accounts are divided into major categories and subcategories. Each major category starts with a particular number and all of the subcategories of fall under a certain category start with the number of the major category.

For example, the first major categories assets and begin with the digit “1”. The first account could be cash and labeled 100. The next could be savings and labeled 101. The second major category, liabilities, starts with a digit “2”, then liability accounts will be labeled in the 200 to 299 range. The first digit tells you the type of account you’re working with.

Your accounting system will generally assign these numbers for you, but when everything was done on paper, it was important to follow these naming conventions to keep things as simple and easy to understand as possible.

Adjusting Your Chart of Accounts

You are free to add an account at any time of the year, but you need to wait until the end of the year to delete old accounts. If you delete an account in the middle of the year, it may mess up your books.

Let’s say that in the middle of the year, a restaurant realizes its business is spending a lot more money on pizza sauce because the new line cook keeps getting the ratio of ingredients wrong when mixing it. Instead of recording it in the food expenses account, the restaurant may decide to create a new account for the pizza sauce.

To do this, first, add the new account “Pizza Sauce” to the chart of accounts. Then, make an adjusting entry to move all of the pizza sauce expenses that had already been recorded in the food expenses account to the new pizza sauce expense account. If the restaurant had already spent $2,000 on pizza sauce up to that point, all you have to do is debit the pizza sauce account $2,000 and credit the food expenses account $2,000.

Structure of a Chart of Accounts

The chart of accounts is a flexible financial organization tool, so each company can and will develop its own COA based on the number of unique factors such as the volume of the business, the nature of the business and the need for external parties to go through the company financial information. Typically speaking, balance sheet accounts are first followed by income statement accounts.

Some organizations may also structure their chart of accounts in such a way that various expenses are listed separately by the department where each department has its own set of expense accounts.

Regardless of how it's done, the COA is important to proper financial reports and record keeping. When it comes time to file and pay income taxes, using the COA makes it easier for your bookkeeper and accounting team to take care of things for you.

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