Module 2.4: Chart of Accounts

In Module 2.3, we discuss the basics of income and expenses categories. These categories are used in both single-entry and double-entry accounting systems. Businesses, such as sole proprietorships which do not need or require balance sheets may use the single-entry system. Some businesses like partnerships or corporations are required to use double-entry systems, but it is good business procedures even for those who aren't required to.

It really is hard to do double-entry accounting by hand and it is now standard to use software to keep track of all the debits and credits required. I have added a document to the Bonus section of the course which lists most of the major accounting software systems out there and some details about them. If you know of one you like that is not listed, please let me know so I can add it.

Let's start our discussion with single-entry accounting systems. These are commonly done with a bookkeeping notebook that you can find at your local office supply store or you can simple make your own with the spreadsheet app you have on your computer. For our purposes here, we will you a spreadsheet.

There are three sections in a single-entry accounting system: date & customer or vendor, income types and expense categories. As you can see, the income is broken down into three

Sample Spreadsheet Bookkeeping System - Income

Date	Customer	Cash	Check	Credit/Debit
01/05/2021	Charles Pearson	$125.00		
01/06/2021	Cheryl Kay		$249.00	
01/07/2021	Sophie Perez	$16.87		
01/08/2021	Captain Kirk			$1259.00
01/09/2021	Marvin James		$959.00	
01/10/2021	Davy Jones			$678.00
01/11/2021	Doctor McCoy			$349.00
01/12/2021	Kathy Hawn		$127.95	
Totals:		**$141.87**	**$1335.95**	**$2286.00**

columns: Cash, Checks, and Credit/Debit. If you are an online business, you may also have a column for services like PayPal.

The other half of the spreadsheet lists all of the expenses by category. I have entered some sample categories for our discussion here. Notice that there are two columns for oil & gas. This example assumes this is a service business like landscaping services that purchases gas & oil for the equipment and for the vehicles. These have to be kept separately because there are two ways to deduct vehicle expenses on your taxes - well go over this in Module 3.3 - so they need to be recorded separately.

Sample Spreadsheet Bookkeeping System - Expenses

Date	Customer	Cash	Check	Credit	Rent	Oil/Gas	Gas Vehicle	Supplies	Equipment	Notes:
01/05/2021	Capital Rentals		$1295.00		$1295.00					
01/06/2021	Herkimer Pierpont		$950.00					$950.00		
01/07/2021	Wawa			$45.00			$45.00			
01/08/2021	Home Depot			$1595.00					$1595.00	Riding Lawnmower
01/09/2021	Lowes			$259.00				$259.00		
01/10/2021	Acme Hardware		$2495.00						$2495.00	Equipment Trailor
01/11/2021	Captain Kirk	$675.00						$675.00		
01/12/2021	David Jones		$74.95			$74.95				
01/13/2021	AT&T			$835.00		$835.00				
01/14/2021	Local Nursery		$945.00					$945.00		
Totals		$675.00	$5759.95	$2734.00	$1295.00	$909.95	$45.00	$2829.00	$4090.00	$0.00

You will also notice a column for equipment/property. Any equipment or property that has a life of more than a year like mowers, computers, or buildings need to be treated separately for tax purposes. When doing your taxes, you have to record the date purchased, the item description and the price paid w/tax and shipping. While your spreadsheet will record what you paid for that equipment during the year, your tax return will record it differently, which we will discuss in Module 3.8.

If you have purchased something on credit, the entire amount is considered to be paid at the time of purchase. As you are paying it off, you need to separate the monthly payment into two parts. You may only deduct the interest you paid on the payments because the interest was not part of the original purchase price, so your would add that to your interest paid column. So, if you are using credit cards or loans, remember to only deduct the interest when you make your monthly payment. [If you were using a software program, you would add the interest to the credit account when reconciling your statement and the software would insert everything where it belongs, including how much you still owe on the credit card.]

It is a best practice to total your income and expenses on a monthly, quarterly and annual basis. This provides two things: the first is that you will know on a continual basis if you are making a profit or not by subtracting your expenses form your income. Knowing this allows you to adjust pricing or purchasing to make sure you are being profitable. The second reason is to tell you have much in estimated tax payments you will need to make which we will touch on in Module 3.2.

Let's move on to double-entry accounting systems. As I said earlier, you will want to decide on a software package to keep this for you. After installing it and entering your company information and before entering any transactions - you need to go in and adjust your Chart of Accounts. The Chart of Accounts is designed to be a map of your business and its various financial parts. It should let you make better decisions, give you an accurate snapshot of your company's financial health, and make it easier to follow financial reporting standards.

Fortunately, most accounting software will start you out with a generic Chart of Accounts and some give you a choice between a retail business and a service business. You just need to tweak it for your business. But to do that, you need to understand what you are looking at which is what we are going examine here.

You may download a sample COA in the download section to the right to help follow along.

A chart of accounts is a list of all your company's "accounts," together in one place. It's like a list of all the names of the columns in a single-entry bookkeeping system, adding in the debt you owe, the money you have put into the business, the money people owe you and putting it all together in a way that can produce financial statements like Balance Sheets, Income Statements, and Profit & Loss Statements. These statements are important if you are talking to possible or current investors in your business, telling you how much profit your company is making and makes it much easier to do your business taxes.

The accounts listed will depend on the nature of your business. For example, a taxi business will include certain accounts that are specific to the taxi business, in addition to the general accounts that are common to all businesses. In this case, the taxi business will include a fuel expense account that is not common to all businesses, but it will leave out an inventory account since the taxi business is a service that does not hold inventory.

While you can add to your Chart of Accounts as your business grows (and probably will), by taking the time to properly set up your COA when starting your accounting system will save you time in the future by minimizing changes and giving you a better year to year comparison of how your business is doing.

*Even if you are hiring an accountant to take care of the bookkeeping for you, they probably don't know how your business works, so it is a good practice to give them a custom Chart of Accounts so that the reports you receive reflect how **you** want to view the profitability of your business. It will also help them understand the type of expenses that your company incurs so that they can be properly be entered in the companies books.*

There are five sections to a Chart of Accounts. The first three sections are used to create the Balance Sheet. They are:

- Assets - Records any resources your company owns that provide value to your company. They can be physical assets like land, equipment and cash, or intangible things like patents, trademarks and software.

- Liabilities - Records of all the debts your company owes. Liability accounts usually have the word “payable” in their name - accounts payable, wages payable, invoices payable. ‘Unearned revenues’ are another kind of liability account - usually cash payments that your company has received before services are delivered.
- Equity - These are a little more abstract. They represent what’s left of the business after you subtract all your company’s liabilities from its assets. They basically measure what your company is worth to its owner or shareholders.

The other two sections are used to create the Income Statement. These are compatible to the two sections of the single-entry bookkeeping system. They are:

- Income - The amount of money that people pay your business, interest received income from scrap, or any other earnings.
- Expenses - The amount of money that you spend on purchases, such as rent, electricity, salary, wages, cost of goods sold, depreciation and any other business expenses. The expense accounts will probably be the section that you customize the most to tailor them to your business, much like you would the expenses in a single-entry bookkeeping system.

The way that the balance sheet and income statement accounts interact with each other is complex, but one general rule to remember is this: revenues increase your equity and asset accounts, while expenses decrease your assets and equity.

The Chart of Accounts has four columns. As you can see,

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

The first column contains the Account Number:

- All Assets start with the number 1.
- All Liabilities start with the number 2.
- All Equity start with the number 3.

- All Income start with the number 4.
- All Expenses start with the number 5.

As it shows on the slide, you should not use concurrent numbers for your accounts. You will probably need to add accounts in the future and if you don't leave gaps in between each number, you won't be able to add new accounts in the right order. For example, assume your cash account is 1-001 and your accounts receivable account is 1-002, now you want to add a petty cash account. Well, this should be listed between the cash and accounts receivable in the chart, but there isn't a number in between them. If you had made the accounts receivable 1-005, then there would be three open spots to put it.

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

The second column contains the Account Description. It represents the type of the account. It should be kept precise but capable of including multiple relevant accounts under a large account. For example, "cash receivables" will be mentioned under the type of asset.

The third column contains the five Account Types: Assets, Liabilities, Equity, Income or Expenses.

The fourth column is the Financial Statement. This represents the financial statement impacted by the accounts, the balance sheet or the income statement.

I hope I haven't lost you yet, but as I said at the beginning of this section - my intent is not make you an accountant, but to give you enough information to make informed decisions so you don't lose the profits that you worked so hard for.

So, hopefully this helps you decide whether you want to keep a simple single-entry bookkeeping system or purchase some software which works as a double-entry bookkeeping system.

BTW, in the bonus section I've included a list of the major accounting software on the market and a little bit about the companies to help you decide which one is right for you.

So, how do you adjust your Chart of Accounts as your business grows?

The rules for making tweaks to your chart of accounts are simple: feel free to add accounts at any time of the year, but wait until the end of the year - and your final year end reports are printed - before deleting old accounts. If you delete an account in the middle of the year, it will probably mess up your books.

If it is new expense category your are adding, just add the new account and start assigning the purchases to your new expense account. But what if you decide you want to split out some expenses from an account you have already been entering into? You need to make a journal entry and this is often the part that really confuses people. So, to finish up this module, we are going to briefly cover it.

For example, if you are in the construction business and have been adding everything you buy at Home Depot to an expense account called 'Construction Supplies'. The price of wood has gone through the roof and you decide that you need to have a better handle on how much of your budget is going to buying wood. How would you handle that?

Well, first you would go to your Chart of Account and create a new account under Expenses. Now all of the wood you buy would be assigned to the wood account and all the rest of the nails and screws would be assigned to the Construction Supplies. But what about all of the wood that you entered under Construction Supplies. How do we move it over to the new Wood account so you can run a report and see how it is affecting your business. We make a journal entry.

Since we are using a double-entry system, two entries are needed for any transaction. The software reads the chart of accounts and does this automatically for you - except when we need to adjust something in the books like this. The most confusing thing in making a journal entry is the terminology. Essentially, a Debit adds to the account and a Credit reduces the other account. Backwards to the way most of us think of the words. So remember that.

Let's say in our example that the Construction Supply account has expenses of $100,000 assigned to it, but of that $60,000 was for wood. Our journal entry would look like this:

Date	Account	Debit	Credit
09.19.2021	Wood	$60,000	
	Construction Supplies		$60,000

In this example, the $60,00 of wood was Debited (or added) to our new account and Credited (or removed) from the Construction Supplies account.

Let's look at one more common example of when a journal entry is needed.   Often the owners or shareholders of small business put some of their own money into the business and it is often done through a journal entry, depending on the software. It would look something like this:

Date	Account	Debit	Credit
09.19.2021	Bank Account	$10,000	
	Capital (Owners Investment)		$10,000

In this example, $10,000 was Debited (or added) to the bank account and $10,000 was Credited (or removed from the Capital account. This could make the Capital account go into the negative until such time as the business pays back the investment. This is often referred to as return of capital, where the bank account is credited and the capital account is debited.

Can you imagine before computers, accountants had to make a double-entry by hand for every single sale or purchase the business made? They earned every penny they charged!

So, there you have it. The basics of setting up your accounting system and how to make adjustments to it.   Most good accounting software provide instructional manuals or videos and I highly advise going through them before starting. Although I can't possibly go through every scenario here - hopefully, what we have discussed here will make it easier to understand the training they provide.

In the next module, we will discuss the reports produced by entering all of this data the proper way.