Mastering the Chart of Accounts – Part 2: Balance Sheet Accounts: Assets, Liabilities, and Equity

In the last blog post we talked about how to set up proper Profit and Loss categories for the chart of accounts. In this post we will continue our discussion with a look at balance sheet accounts and how to think about assets, liabilities, and equity accounts.

The Balance sheetsprovide a snapshot of the company's finances, listing assets, liability, and equity for a company. The balance sheet is typically used to calculate the net worth of the business, and includes liabilities, cash, and equipment. A basic tenet of double-entry bookkeeping is that the total assets (what the company owns) should equal the liabilities plus equity, i.e. the books should balance. Subtracting the liabilities form the assets reveals the net worth of the business.

Assets: The company's assets are used in the operation of investment activities of the business, those tangible elements that represent the material goods that allow you to operate your business: vehicles, equipment, buildings, and even invoices or loans to customers. In setting up the chart of accounts, give each asset account its proper type and name: e.g. bank account "WFchecking" , long-term asset "Leasehold Improvements.

When setting up the chart of accounts, it's best to assemble assets by the correct type:

1. Cash, including petty cash, bank accounts, investments, etc.

2. Items being held specifically for conversion into cash, such as accounts receivables, etc.

3. Items that can be readily converted into cash. Depending on the type of business, these can include inventory such as raw materials, direct material, or finished goods; or for retailers merchandise inventory and store supplies; or for service industries contracts in progress or work completed.

4. Items that cannot be converted quickly into cash but where their cost provides future benefits. These might include long-term investments, or property and plant equipment that might be more difficult to liquidate. Related items could be intangible assets such as patents.

Liabilities: The company's liabilities are claims against the business or monies and goods owed to others. Normally, the biggest liabilities are to suppliers. Set up liabilities in the chart of accounts by giving it its proper name such as accounts payable, loans payable, wages payable, payroll taxes, etc. Liability accounts are separated into current (short-term) liabilities that need to be repaid within 12 months, and long-term liabilities that usually are repaid more than a year from the date acquired.

1. Current liabilities are generally those obligations that need to be paid within the current operating cycle. They include things such as demand notes, accounts payable, employee benefits, sales tax, payable interest and estimated tax payments.

2. Long-term liabilities, which are generally debt and fiscal obligations due more than one year away. Typical long-term liabilities would include long-term bank loans, notes payable, and long-term principal payments.

Equity: Equity is the company's claim to business assets or property; assets that are owned by the company's owners after all liabilities are paid. In setting up the chart of accounts, how equity is accounted for depends on the legal structure of the business. The equity accounts report the Owner's Capital Invested and the Accumulated Profit and Loss of the business since it was established.

· Sole proprietorship tracks equity as owner's capital and owner's draw

· A partnership of limited liability company (LLC) uses partner's or member's capital and partner's or member's draw

Set up each equity account with a unique and proper name.

Note that unlike income and expense accounts, asset, liability, and equity accounts are called "permanent accounts" because they carry over from year to year, and their values adjust accordingly. The income and expense accounts are called "temporary accounts" since their value is calculated at the end of each year as the accounts are closed.

Many organizations elect to use a numbering system for their chart of accounts, assigning a reference number to each category. No matter how it is structured, the chart of accounts ultimately organizes and tracks all business activities, making it easy to generate reports and track the financial history and progress of the business.