Principles of Accounting
Help Lesson #1

Understanding Accounts

By Laurie L. Swanson

Building the Foundation

Before we can begin to analyze and record transactions, we must first build a foundation of basic terms, concepts, and accounts.

The first bricks in our foundation are laid by defining the five categories of accounts:

- **Cash**: Any amount to be received, and other items used to operate a business.
- **Liability**: Any amount owed by a company.
- **Owner’s Equity**: The owner’s rights to assets in the company.
- **Revenue**: Amounts earned by a company for providing a good or service.
- **Expense**: The costs of earning revenue.

For better classification of transactions, each of these major categories is broken down into accounts.

Some common accounts are:

- **Cash**
- **Accounts Receivable**
- **Equipment**
- **Office Supplies**
- **Building**
- **Accounts Payable**
- **Notes Payable**
- **Mortgage Payable**
- **K. Jones, Capital**
- **K. Jones, Drawing**
- **Consulting Revenue**
- **Interest Income**
- **Income Tax Payable**
- **Plumbing Fees Earned**
- **Sales**
- **Utilities Expense**
- **Rent Expense**
- **Salaries Expense**

Explanation of Asset Accounts

Recall that assets are cash, amounts to be received, and other items used to operate a business.

- **Cash**: An account used to record the cash used in operating a business. This usually refers to cash maintained in a checking account.
- **Accounts Receivable**: An account used to record amounts due from customers. Generally used when a company offers revolving credit to its customers.
- **Equipment**: An account used to record the value of the building used in operating a business. The building is considered an asset even if the company has a mortgage on the building.
- **Office Supplies**: An account used to record the value of office supplies on hand. Usually refers to unused supplies.
Explanation of Liability Accounts

Recall that liabilities are any amounts owed by a company. The word payable is used in most liability account titles. Payable means "owed".

Accounts Payable-an account used to record amounts owed to creditors. This account is usually used for informal, revolving credit.

Notes Payable-an account used to record amounts owed that are formally acknowledged by a written, signed document known as a note.

Mortgage Payable-an account used to record amounts due on a mortgage.

Explanation of Revenue Accounts

Recall that revenue represents amounts earned by a company for providing a good or service.

Fees Earned-an account used to record amounts earned by a business when a service has been provided.

Sales-an account used to record amounts earned by a business when a good has been provided.

Revenue is considered earned even if no cash has been received.

Revenue accounts generally describe the type of service or product that was provided and contain such key words as earned, income, or revenue.

An Unusual Liability Account

Although the word payable is used in most liability account titles, some liability accounts contain the word unearned.

Unearned Fees-a liability account used when customers pay for services before any services have been rendered. In this case, services, not money, are owed.

Explanation of Expense Accounts

Recall that expenses are the costs of earning revenue.

Expense-accounts used to record the costs of doing business.

Expenses represents the costs of items that get “used up” in the process of operating a business.

The word “expense” in account titles is preceded by a word that describes the type of expense that was incurred. Some common expenses are rent, interest, utilities, wages and salaries, and automobile fuel.

Expenses are considered incurred even if no cash has been paid.

Explanation of Owner’s Equity Accounts

Recall that owner’s equity represents the owner’s rights to assets in the company.

Capital-an account used to record the owners investments in the business as well as the return on investment generated by operating the company. Owner investments may be in the form of cash or other assets. The capital account is always preceded by the owner’s name, for example, K. Jones, Capital.

Drawing (Withdrawals)-an account used to record cash and other assets withdrawn from the company by the owner. The drawing account is always preceded by the owner’s name, for example, K. Jones, Drawing.

Chart of Accounts

A Chart of Accounts is a listing of each specific account under major account categories.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Owner’s Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>Karen Jones, Capital</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>Karen Jones, Drawing</td>
</tr>
<tr>
<td>Office Supplies</td>
<td>Revenue</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>Consulting Income</td>
</tr>
<tr>
<td>Building</td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td></td>
</tr>
<tr>
<td>Mortgage Payable</td>
<td></td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
</tr>
<tr>
<td>Rent Expense</td>
<td></td>
</tr>
<tr>
<td>Utilities Expense</td>
<td></td>
</tr>
<tr>
<td>Wages Expense</td>
<td></td>
</tr>
<tr>
<td>Interest Expense</td>
<td></td>
</tr>
</tbody>
</table>
Chart of Accounts

Accountants refer to the Chart of Accounts to help them determine the appropriate accounts in which to record transactions.

See if you can Identify the Correct Category for each Account Below

<table>
<thead>
<tr>
<th>Accounts Payable</th>
<th>Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>K. Jones, Drawing</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>Mortgage Payable</td>
</tr>
<tr>
<td>Salaries Expense</td>
<td>Office Equipment</td>
</tr>
<tr>
<td>K. Jones, Capital</td>
<td>Concession Sales</td>
</tr>
<tr>
<td>Utilities Expense</td>
<td>Interest Income</td>
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</tbody>
</table>

Click to See the Placement of All Accounts

Categorizing Accounts

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<td>Utilities Expense</td>
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</table>

Next Step

Now that we have laid a partial foundation, we can begin to learn how to analyze transactions.

Choose Help Lesson #2 – Analyzing Transactions