**Chapter 2**

**Account Descriptions.** The following is a description of the different types of asset, liabilities and equity accounts and should be read before class.

**Asset Accounts** Assets are resources owned or controlled by a company, and those resources have expected future benefits. Most accounting systems include (at a minimum) separate accounts for the assets described here.

A ***Cash*** account reflects a company's cash balance. All increases and decreases in cash are recorded in the Cash account. It includes money and any medium of exchange that a bank accepts for deposit (coins, checks, money orders, and checking account balances).

***Accounts receivable*** are held by a seller and refer to promises of payment from customers to sellers. These transactions are often called *credit sales* or *sales on account* (or *on credit*). Accounts receivable are increased by credit sales and are decreased by customer payments. A company needs a separate record for each customer, but for now, we use the simpler practice of recording all increases and decreases in receivables in a single account called Accounts Receivable.

A ***note receivable***, or promissory note, is a written promise of another entity to pay a definite sum of money on a specified future date to the holder of the note. A company holding a promissory note signed by another entity has an asset that is recorded in a Note (or Notes) Receivable account.

***Prepaid accounts*** (also called *prepaid expenses*) are assets that represent prepayments of future expenses (*not* current expenses). Common examples of prepaid accounts include prepaid insurance, prepaid rent, and prepaid services (such as club memberships).

Prepaid accounts expire with the passage of time (such as with rent) or through use (such as with prepaid meal tickets). When financial statements are prepared, prepaid accounts are adjusted so that (1) all expired and used prepaid accounts are recorded as regular expenses and (2) all unexpired and unused prepaid accounts are recorded as assets (reflecting future use in future periods).

To illustrate, when an insurance fee, called a *premium*, is paid in advance, the cost is typically recorded in the asset account Prepaid Insurance. Over time, the expiring portion of the insurance cost is removed from this asset account and reported in expenses on the income statement. Any unexpired portion remains in Prepaid Insurance and is reported on the balance sheet as an asset.

***Supplies*** are assets until they are used. When they are used up, their costs are reported as expenses. The costs of unused supplies are recorded in a Supplies asset account. When supplies are used, their costs are transferred from the asset accounts to expense accounts.

***Equipment*** is an asset. When equipment is used and gets worn down, its cost is gradually reported as an expense (called depreciation). Equipment is often grouped by its purpose.

***Buildings*** such as stores, offices, warehouses, and factories are assets because they provide expected future benefits to those who control or own them. Their costs are recorded in a Buildings asset account. When several buildings are owned, separate accounts are sometimes kept for each of them.

The cost of ***land*** owned by a business is recorded in a Land account. The cost of buildings located on the land is separately recorded in one or more building accounts.

**Liability Accounts** Liabilities are claims (by creditors) against assets, which means they are obligations to transfer assets or provide products or services to others. **Creditors** are individuals and organizations that have rights to receive payments from a company. If a company fails to pay its obligations, the law gives creditors a right to force the sale of that company's assets to obtain the money to meet creditors' claims. When assets are sold under these conditions, creditors are paid first, but only up to the amount of their claims. Any remaining money, the residual, goes to the owners of the company.

Creditors often use a balance sheet to help decide whether to loan money to a company. A loan is less risky if the borrower's liabilities are small in comparison to assets because this means there are more resources than claims on resources. Common liability accounts are described here.

***Accounts payable*** refer to oral or implied promises to pay later, which usually arise from purchases of merchandise. Payables can also arise from purchases of supplies, equipment, and services.

A ***note payable*** refers to a formal promise, usually denoted by the signing of a promissory note, to pay a future amount. It is recorded in either a short-term Note Payable account or a long-term Note Payable account, depending on when it must be repaid.

**Unearned revenue** refers to a liability that is settled in the future when a company delivers its products or services. When customers pay in advance for products or services (before revenue is earned), the revenue recognition principle requires that the seller consider this payment as unearned revenue. Examples of unearned revenue include magazine subscriptions collected in advance by a publisher, sales of gift certificates by stores, and season ticket sales by sports teams. When products and services are later delivered, the earned portion of the unearned revenue is transferred to revenue accounts such as Subscription Fees, Store Sales, and Ticket Sales.

Revenue Spread The **New Orleans Saints** have *Unearned Revenues* of about $60 million in advance ticket sales. When the team plays its home games, it settles this liability to its ticket holders and then transfers the amount earned to *Ticket Revenues*. 



**Point:** Equity is also called *net assets*.

***Accrued liabilities*** are amounts owed that are not yet paid. Examples are wages payable, taxes payable, and interest payable. These are often recorded in separate liability accounts by the same title

**Equity Accounts**

The owner's claim on a company's assets is called *equity*, or *stockholders' equity*, or *shareholders' equity.*

Equity is impacted by four types of accounts: common stock, dividends, revenues, and expenses. We show this visually by expanding the accounting equation.



When an owner invests in a company in exchange for common stock, the invested amount is recorded in an account titled **Common Stock.** Any further owner investments are recorded in this account.

When the company pays any cash **dividends**, it decreases both the company's assets and its total equity. **Dividends are not expenses of the business. They are simply the opposite of owner investments**. A **Dividends** account is used in recording asset distributions to stockholders (owners).

**Revenues and expenses** also impact equity.

Examples of revenue accounts are Sales, Commissions Earned, Professional Fees Earned, Rent Revenue, and Interest Revenue*. Revenues increase equity* and result from products and services provided to customers.

Examples of expense accounts are Advertising Expense, Store Supplies Expense, Office Salaries Expense, Office Supplies Expense, Rent Expense, Utilities Expense, and Insurance Expense. *Expenses decrease equity* and result from assets and services used in a company's operations.

The variety of revenues and expenses can be seen by looking at the *chart of accounts* that follows the index at the back of this book.