TYPES OF MAJOR ACCOUNTS

Learning Objective

- To discuss the five major accounts

Key Understanding

- Understanding of the five major accounts is important in preparing a chart of accounts

Key Question

- What are the five major accounts?

Current Assets

Current assets are all assets which are expected to be realized within the ordinary course of business, or a span of twelve months, whichever is longer. *Realization* here only means that these assets are expected to be converted into cash, sold or disposed after a certain time, or through the passage of time.

1. Cash

- The most basic and familiar of all the assets—cash—is generally classified as a current asset. But did you know that cash not only includes money? *Money* means everything composed of bills and coins, considered as legal tender (such as the Philippine Peso in the Philippines), or legal tenders of other nations (such as the U.S. Dollar).
- Cash, on the other hand, also includes money in the form of *bank deposits* in checking accounts and savings accounts. It can also include checks, such as those provided by customers in payment for goods or services received.

Current Assets

Cash

- Some companies would also include *cash equivalents* in the cash classification. Cash equivalents are short-term investments which are considered subject to negligible changes in fair value, and are maturing within three months from the date of their purchase. Examples of these would include three-month BSP Treasury Bills, certificates of deposit, and money market instruments.
- It is important to note that among all assets, cash is considered the most liquid, as reflected by its ready usability through almost all transactions a company can enter. As such, the cash account is routinely monitored through the statement of cash flows.

Current Assets

2. *Accounts Receivable*

- Accounts receivable are oral promises to the entity to receive cash at a later date. They usually arise from the normal course of business, such as selling goods or delivering services, but can also come from non-trade events, such as you lending your friend. Those which arise from the normal course of business are called *trade receivables,* and those which do not are either called *non-trade receivables* or simply *other receivables.*
- While they can be just as easily convertible and liquid as cash, definitely, not all receivables can be collected. Hence, companies also set up a contra-asset account, called *allowance for doubtful accounts or bad debts allowance* that estimates how much of their current receivables are uncollectible.

Current Assets

3. *Short-term Investments*

- The short-term investments account contains the company's investments in low risk, highly liquid assets such as bonds and stocks, which are expected to be liquidated in less than a year. Most often, short-term investments are entered into by the company to make the most income out of its otherwise idle cash. This income is earned through interests, dividends, and price appreciations, usually exceeding income earned from interests on bank savings deposits.
- Companies with sound cash management would tend to have this account balance, compared to those which are not doing as great. However, the primary downside of putting excess cash into short-term investments is their added risk of change in value and lesser readiness for conversion.

Current Assets

4. *Notes Receivable*

- Similar to the accounts receivable, a notes receivable account represents promises to the entity to receive cash at a later date, with the main distinction that notes receivable are all *written,* and hence, more formal than accounts receivable. This added formality feature ensures that, in the case of a default by the borrower, the company can seek additional legal remedies to recover what has been lent. And by its written nature, notes receivable tend to have longer maturity dates than accounts receivable, but still are generally considered as within the operating cycle. Notes receivable are also sometimes called as *promissory notes.*

Current Assets

5. *Inventories*

- As you look at a *sari-sari* store across the street, you see a lot of items hanged and displayed on the shelves, such as candies, chips, canned goods, and toiletries—all ready to be sold. These items are called *inventory in accounting parlance.* Aside from these finished goods which are available for sale, inventory also includes raw materials, work-in-process items, and supplies.
- Raw materials are basically inputs for producing other materials. Once they are entered into production, but awaiting completion, they are called *work-in-process items.* Meanwhile, there are items which do not actually serve as an input for a product but are nevertheless used during the production—these are called *supplies.* Finally, upon completing production, the end products are now called as *finished goods.*

Current Assets

6. *Prepayments*

- A *prepayment* is an amount simply paid in advance for goods or services anticipated to be received by the entity in the future. In the previous example, you have paid money in advance to acquire load, from which you expect your network to send your messages (i.e., to provide a service) as long as you have enough load to carry on.
- On a broader perspective, *prepayments* can be other sorts of things provided that the two requirements in the definition have been met. Usual examples are rent, salaries, utilities, and insurance paid in advance. Prepayments would only cease to be as such when they are finally used up, and this is applicable to all the examples mentioned before.

Noncurrent Assets

- All other assets which are not current basically fall into the definition of noncurrent assets. Take note that they necessarily do not need to have at least twelve months remaining before their expected realization; as long as they do not meet the current asset classification, they are classified here.

Noncurrent Assets

1. *Investments*

- Perhaps the most liquid of the noncurrent assets, the investments account include all the company's investments which it does not expect to realize within one year. Different from the short-term investments account which usually include only highly liquid investments such as bonds and stocks, the investments account here can also include other forms of investments, such as real estate, long-term notes, government treasury bills, and funds set aside for long-term purposes.

Noncurrent Assets

2. *Fixed Assets*

- *Fixed assets* are what can be called as the most tangible, longest-serving assets a company can have. They are expected to not be converted into cash immediately, and are regularly placed as means of production. Examples of fixed assets are land, land improvements, buildings, machineries, equipment, furniture and fixtures and land improvements. Collectively, they can be also called as property, plant and equipment (PPE).
- Unlike current assets, they are not usually consumable and are only used through utilization. Fixed assets, with the exception of land, also gradually deteriorate with the passage of time, through usage, normal wear-and-tear, and obsolescence. Such deterioration is more properly termed as *depreciation,* a form of an expense. On a personal level, your mobile phones, laptops, and other gadgets can be considered as your fixed assets.

Noncurrent Assets

3. *Intangible Assets*

- In contrast to fixed assets, intangible assets lack physical substance, and yet are similarly realizable over long periods of time. Being intangible, it is harder to measure their value and evaluate them as assets, compared to tangible assets. Prime examples include patents, copyrights, franchises, goodwill, trademarks, and licenses. Often, they are simply represented by written documents or certificates stating their description and ownership status.
- Over time, the value of most intangible assets would likewise decrease; hence, similar to fixed assets, intangible assets are also subject to some form of depreciation, which is more appropriately called as *amortization.*

Noncurrent Assets

4. *Other Assets*

- All remaining items which do not fall into any of the accounts mentioned above are classified together as *other assets.* This account serves as a catch-all for assets which are usually very much unique or hard to classify. As a practical consideration, it is favorable to limit the usage of this account to encourage more distinct classifications.

Current Liabilities

These are liabilities which are expected to be settled or paid out by the entity within twelve months. Paying out does not necessarily mean payment through cash, but can also include conversion and/or refinancing.

1. *Accounts Payable* - it is the opposite of Accounts Receivable. While in accounts receivable, the entity is on the receiving side, the entity is now on the paying side, hence, the borrower.
2. *Notes Payable*- are written promises of the entity to pay a sum certain in a future determinable time. While these can usually arise from larger trade or business transactions which additional formality from accounts payable is necessary, they can also arise from the regular borrowings of the entity. They are the opposite of notes receivable, in that the entity now, instead of being the lender, is the borrower.

Current Liabilities

3. *Accrued Liabilities* - are all other accounts which the company should pay, arising from the normal course of business. Throughout the operating cycle, it is very much possible that the company has already received benefits from certain events, yet has still been unable to pay for it. In a way, accrued liabilities can also be considered the opposite of prepaid assets. This is very much true as regards to *unearned revenues,* a form of an accrued liability related to goods or services that the entity has yet to deliver, but has already received payment from a customer.
4. *Current Portion of Long-term Debts*- these are long-term debts payable within the coming year. Some long-term debts, due to their large principals, usually have features that allow the borrower to pay on an installment basis, so as to ease them the burden of a heavy cash outflow from a single maturity date.

Current Liabilities

5. *Other Payables*

- Other payables include those which are due from the entity outside the normal course of its business. These include common items such as dividends payable and interest payable, and unusual items such as payables arising from lawsuits. As long as they are payable within the year but do not enter into the other previous current classifications, they can be included in this catch-all classification.

Noncurrent Liabilities

Noncurrent liabilities form the residual portion of liabilities. By strict definition, these are liabilities which the entity expects to settle after more than a year, or have the legal or contractual capacity to defer payment accordingly.

Bonds Payable-

- are even a degree more formal than notes payable. Bonds payable are a form of long-term debt, often in huge sums, contained in an agreement called as the *bond indenture.*
- Unlike notes payable, bonds payable have stated interest rates, which may differ from prevailing market interest rates, causing their fair values to change from time to time. They are usually issued by the government, banks, and huge corporations seeking huge financing sources. Bonds which have principal that mature in a single date are called *term bonds;* those that mature in multiple dates are called *serial bonds.*

Equity / Owner's Equity / Stockholders' Equity

- Equity is the residual interest of the owners in the assets of the business after considering all liabilities. It is equal to total assets minus total liabilities.
- To illustrate the concept of equity, consider a sole proprietor who wants to start a business. In order to fund the assets of the business, the sole proprietor obtains a loan from a bank in addition to investing his or her own money. In this case, the business technically has two owners: the creditor bank and the sole proprietor.
- These two entities have claims in the assets of the business. But because the sole proprietor has the obligation to eventually pay for the loan, the creditor bank has the greater claim on the business assets. To determine how much really of the business the sole proprietor owns, he or she has to deduct the loan he or she has to pay for from the total assets of the business.

Equity / Owner's Equity / Stockholders' Equity

- In the case of sole proprietorships and partnerships, equity is also called owner's capital. Balance sheets of these entities have simple titles for the owner's equity components (usually the name of the sole proprietor or the partners followed by a comma and the word Capital, i.e., Juan Dela Cruz, Capital). A sole proprietorship has only one equity component while a partnership has as many components as there are partners.
- In the case of corporations, it is more appropriate to use the term *shareholders' equity* or *stockholders' equity*. Shareholders' equity is more complex than owner's capital because it has many components which vary according to the complexity of the corporation's capital structure. The shareholders' equity section of the balance sheet usually has a common stock account, a preferred stock account, an additional paid-in capital account, and a retained earnings account.

Equity / Owner's Equity / Stockholders' Equity

Common Stock - is a security which represents ownership in a corporation. Those who own common stock of a corporation are called *common stockholders.* A common stockholder has many rights among which are the following:

1. Right to vote in the stockholders' meetings
2. Right to receive dividends
3. Pre-emptive right which is the right to be offered first to buy additional shares in the event of a future issuance

All common stock comes with a *par value.* This is the legal nominal value assigned to it, and it is illegal for it to be issued for less than this price. In the balance sheet, the common stock account represents the number of common shares issued and outstanding multiplied by the stock's par or stated value.

Equity / Owner's Equity / Stockholders' Equity

Preferred Stock

- Similar to the common stock account, the *preferred stock account* represents the number of preferred shares issued and outstanding multiplied by the stock's par value. A preferred stock is also a security which represents ownership in a corporation, and owners of preferred stock are called *preferred stockholders.*
- The difference between a preferred stock and common stock is the preferred stocks' preference as to corporate dividends and/ or liquidation. When a corporation declares a dividend, preferred stockholders are given priority over common stockholders. Preferred shares almost always come with a par value and a stated interest.

For example, Happy Donuts Corporation has 1 000 common shares and 1 000 preferred shares outstanding. The par value of common shares and preferred shares are ₱5 and ₱10, respectively. The stated interest rate of the preferred shares is 5%. If the company declared a ₱2 000 cash dividend, the common shareholders and the preferred shareholders each get ₱1 500 and ₱500 pesos respectively, based on the following computation:

Preferred Shareholders:

- 1000 Preferred Shares x ₱10 Par Value of Preferred Shares x 5% = ₱500 to Preferred Shareholders

Common Shareholders:

- ₱2 000 Total Cash Dividend – ₱500 to Preferred Shareholders = ₱1 500 to Common Shareholders

Additional Paid-in Capital

- *Additional paid-in capital,* also called share premium, is the excess over par-value contributed by the company's shareholders in a stock issue. It can either be from the issuance of common shares or preferred shares. For example, a company issues 5 000 common shares with a par value of ₱10 for ₱15 per share. The additional paid-in capital from this share issuance is ₱5 (₱15 – ₱10) per share for a total of ₱25 000. Additional paid-in capital arises because the selling value of a stock is almost always greater than its par value. In other words, the par value is the minimum amount a share can be issued for.

Retained Earnings

- *Retained earnings* represent the accumulated net income from operations over several periods. It is a measure of how much the company earned since day one of its operations. Sometimes, a company's investors (or shareholders) will want to reap the benefits of their investments. When the company gives back to its shareholders because it has been operating successfully over several periods, it declares *dividends* which reduce retained earnings. To gain a better understanding of retained earnings, it would be appropriate to discuss increases and decreases in equity.

Increases in Equity

- Equity increases as a result of revenues, gains, or capital contributions. *Revenues* are the amounts received by a business earned as a result of selling something or rendering a service. It is the increases in equity as a result of day-to-day operations.
- Note that the amount of revenues for a period does not necessarily equate to the amount of actual cash received in that period of time. Revenues are only recognized when incurred and when an entity already incurs the related expenses.
- For example, if a magazine publishing company is given cash in advance to deliver magazines to its subscribers, the company should not yet recognize revenues because it has not yet delivered. Only when the company has already incurred expenses to produce the magazines and delivered them to the subscribers should the company recognize the revenues. But how should the company classify the cash it initially received if it should not be revenue? In this case, the cash received is called *deferred revenue,* and this is considered a liability.

Revenues can be classified as follows:

1. Operating Revenue – revenues that originate from main business operations (e.g., sales, service revenue, etc.)
2. Non-operating Revenues – revenues that do not originate from main business operations and are a result of some side activity (e.g., interest revenue, rent revenue of a business not engaged in the renting industry).

Examples of revenue accounts are the following:

1. Sales Revenue –main source of revenue for businesses that sells products (e.g., supermarkets, convenience stores, food manufacturers)
2. Service Revenue – main source of revenue for businesses that render services (e.g., barber shops, accounting firms)
3. Interest Revenue – revenue earned as a result of investment in debt securities or receivables from other entities
4. Dividend Revenue – revenue earned as a result of dividend declaration of a company where in a business has invested stocks
5. Contributions Revenue – revenue earned by not-for-profit organizations usually in the form of donations by outside parties.

- *Gains* are increases in equity as a result of non-recurring activities or the increase in value of investments. Non-recurring activities include the sale of company noncurrent assets.

- *Capital contributions* are increases in equity as a result of transactions with owners. It can be in the form of cash and non-cash assets given by owners for use in the business. Measuring the amount of capital contributions for sole proprietorships is often difficult because the contributions are usually personal assets of the proprietor. These assets are often used for both personal and business reasons. This is usually not the case for partnerships because they keep books of accounts separate from the owners.

- *Decreases in Equity*- Equity decreases as a result of expenses, losses, and distribution to owners. *Expenses* are the amounts consumed by the business to operate. They are the result of attempting to generate revenues. Just like revenues, they are the result of day-to-day operations and do not always equal the amount of cash used up in a given period.

Examples of Expense accounts are the following:

1. Cost of Goods Sold – when inventory is sold, the cost of goods sold reflects what the company incurred to make the inventory sell (in manufacturing companies) or to buy them (in merchandising companies)
2. Utility Expense – include water and electricity and reflects the amount paid for to utility companies like MERALCO and Manila Water Company, Inc.
3. Depreciation Expense – a result of using building and equipment
4. Office Supplies Expense – a result of using up office supplies
5. Insurance Expense – a result of insurance paid for expiring over time
6. Salaries Expense – a result of recognizing salaries of company employees
7. Bad Debt Expense – an estimate of how much accounts receivable the company will not be able to collect
8. Interest Expense – interest incurred as a result of borrowing money

- *Losses* are the direct opposite of gains. They are decreases in equity as a result of nonrecurring activities or decreases in value of assets. If the value of an investment in stock decreases over time, a loss also exists.
- *Distribution to owners* is assets given to owners, usually in cash. For corporations, they are called dividends. Dividends can be viewed as rewards for the stockholders for investing their money with the corporation. They ideally should come from the retained earnings of a business because they represent the fruits of the company's hard work. If the dividends originate from some other equity account, they are called *liquidating dividends* and indicate that the company is closing down, if not, reducing in size. *Treasury shares* are technically also distribution to owners. However, instead of being viewed as rewards like dividends, treasury shares are usually bought for an underlying motive. Treasury shares also reduce owner's equity.

- If we add up all the revenues and gains and deduct all the losses and expenses, we get a business' ***net income*** for the period. Net income can also be called ***net earnings***. All the net incomes throughout years of a company's operations accumulate in the retained earnings account. The transactions with owners (capital contribution and distribution to owners) affect shareholder's equity but they never form part of net income.