How to Create Your Chart of Accounts Blueprint

Creating a Scalable Foundation For Your Business Finances

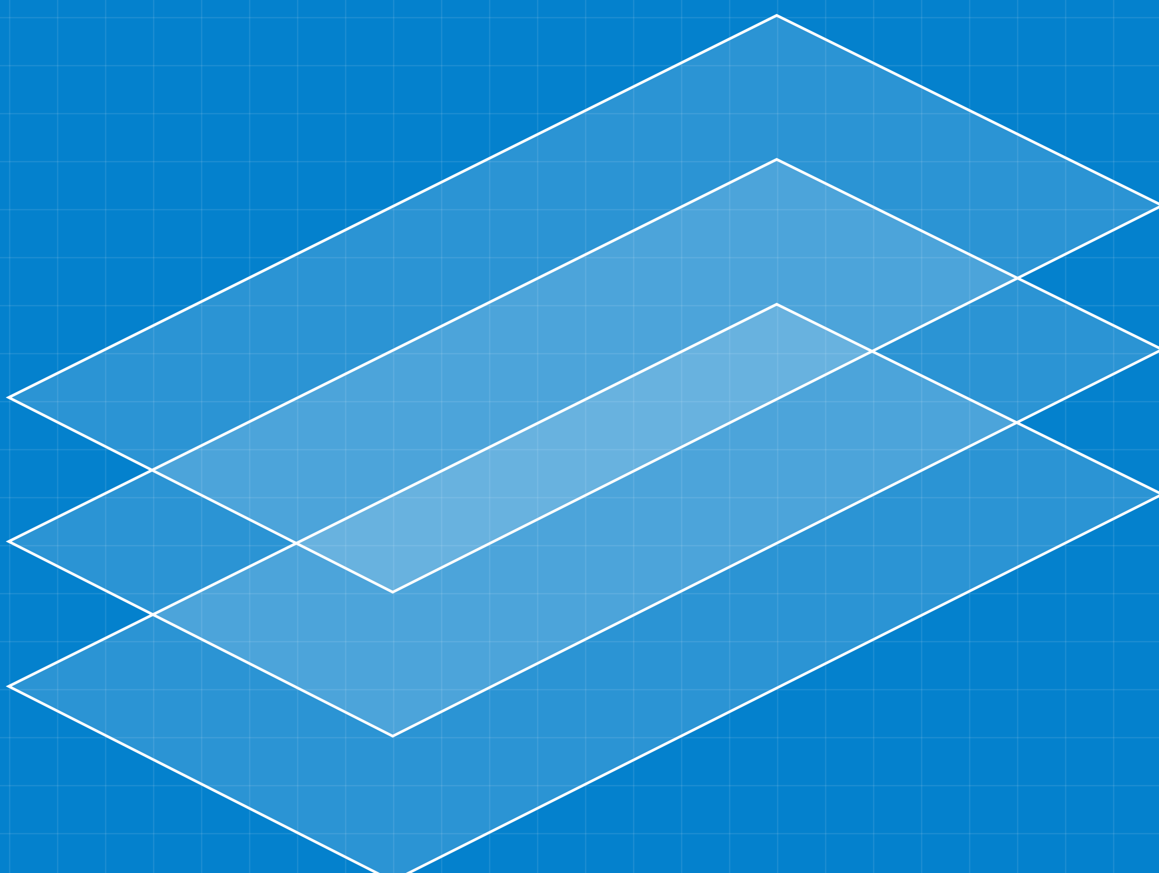

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Chart of Accounts Blueprint

No engineer would think of constructing a bridge without a blueprint that outlines the design and provides an overall concept for the project. The blueprint defines strategy and expected outcomes, and is the guiding document throughout construction. Most importantly, developing the blueprint uncovers potential problems BEFORE the project begins, helping to avoid costly issues down the line.

Creating a blueprint is key to planning and is an essential step in any process.

The finance field is no exception. In the late nineteenth century, European accountants developed the basic framework to categorize and track revenue and expenses that we know today as the Chart of Accounts (COA). Despite being around for over a hundred years, creating a COA can be intimidating, especially if you've never done it before. And anyone who has struggled with a COA that wasn't set up properly knows how crucial this step is for any business.

There is a host of trade-offs to consider and your COA can be configured in a number of different ways depending on your particular business, so you need to put careful thought into setting it up appropriately.

Our goal with this guide is to help simplify the process. We'll examine three key focus areas to guide you in creating an effective COA that will form a solid foundation for your business accounting requirements.

SPECIAL THANK YOU

Thank you to Blake Oliver, owner of **Cloudsourced Accounting** for contributing to this guide. Blake has over 10 years of experience as a bookkeeper and accountant, managing accounting systems for a variety of small businesses and non-profits.

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I. The Basics

The COA is a listing of the accounts that a company has established to record financial transactions in its general ledger. It consists of balance sheet accounts (assets, liabilities, stockholder's equity) and income statement accounts (operating revenues and expenses, non operating gains and losses).

A well-crafted COA organizes all of the company's information, reporting, and accounting requirements and is constructed using a consistent terminology established by the business.

It's a framework that enables structured reporting and understanding of the company's financial health and performance and becomes the central point for managers to extract relevant data and make decisions for the organization.

COMMON SETUP

Your COA should match the financial structure of the business. COAs will differ between companies but they all have the same basic setup. The order of your COA should align with that of your financial statements. A common order is as follows:

- **Assets**
- **Liabilities**
- **Equity**
- **Revenue**
- **Cost of Goods Sold**
- **Expenses**
- **Other Revenue & Expenses**

There are a number of style options available when it comes to setting up the numbering system for your COA. Smaller companies sometimes use a simple three-digit methodology where the first number represents a major account category (for example 1 for assets, 2 for liabilities, 3 for equity, 4 for revenue, and 5 for expenses). The second and third numbers break down the larger accounts into sub-accounts. Larger organizations may expand this further using more digits to add more detail as needed. The key is to choose a style that is consistent, easy to understand, and fits your company's business operation.

PRO TIP

Best practice is to order your accounts by accounting type, and then in order of liquidity.

Your numbering system should align with the list of financial statement categories listed above. The sub-accounts can be used to break out whatever detail you feel is necessary for reporting. Each company has different reporting requirements, so design your COA to fit your needs. If most of your expenses are in the selling categories, you may want to go into more detail in that area. If you are a manufacturing-based company, you'll want a more detailed breakdown in operating expenses.

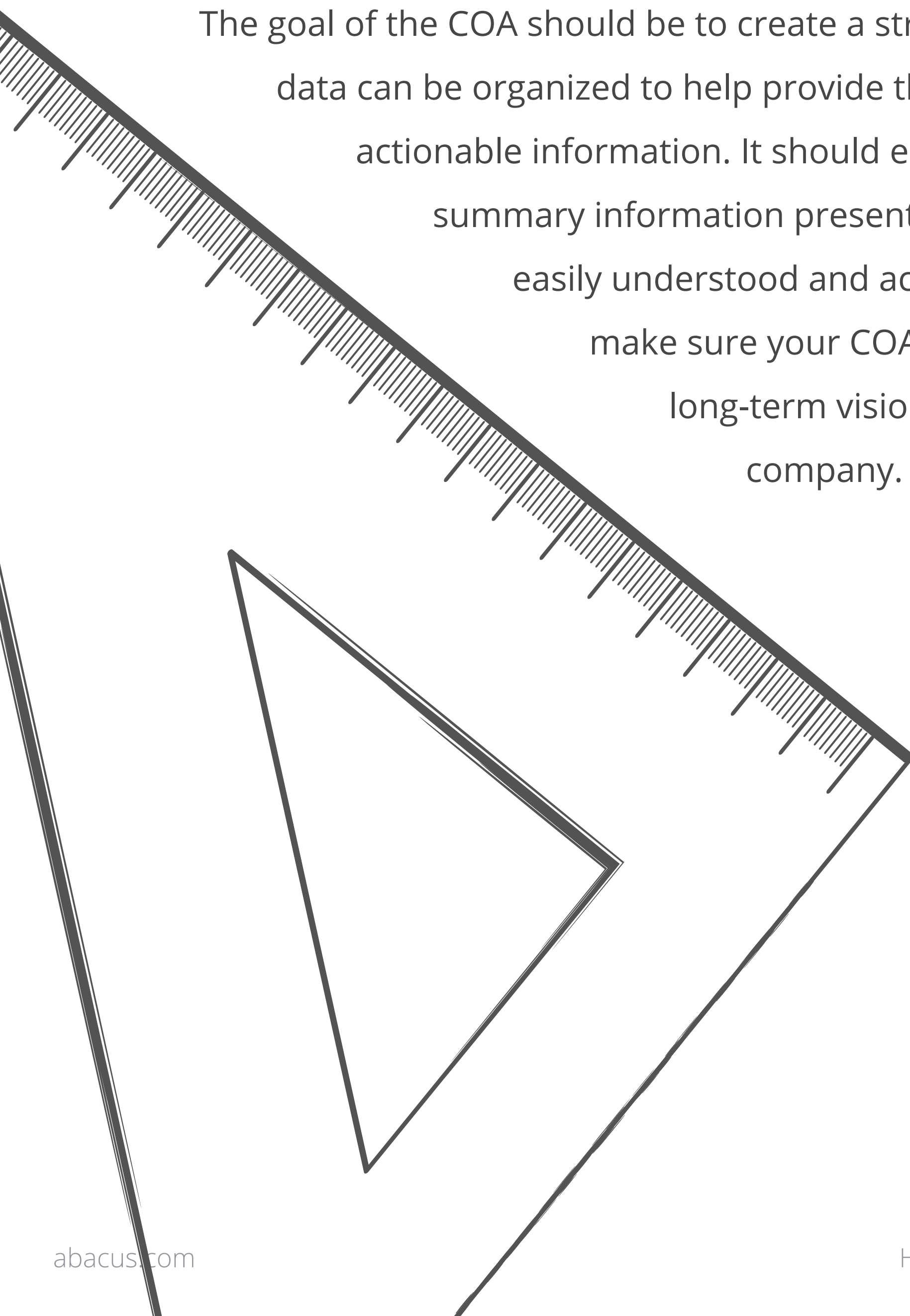
The complexity of your business structure is another factor to consider. A small, single location shop can have a relatively simple COA. A multi-site corporation with many divisions, plants, and departments will likely require a more complex COA with expanded reporting flexibility.

When numbering your accounts, it's important to leave open numbers between major account categories to accommodate future growth or change. Accounts can be any number of digits or characters, and the more options you use the more flexible your reporting can be. However, keep in mind that if your COA becomes too complicated, it may be tough to maintain consistency, leading to a cumbersome COA down the road.

THE GOAL OF YOUR COA

By investing time and thought into its creation, the COA can turn into more than simply a repository for transactional entries. The process of developing or reconfiguring the COA can be an opportunity to rethink the company's information requirements. It starts to provide the basis for stakeholders to be able to build meaningful business insights out of financial data to improve the decision making process.

The goal of the COA should be to create a structure in which data can be organized to help provide the business with actionable information. It should enable detailed and summary information presented in a way that is easily understood and actionable. Finally, make sure your COA aligns with the long-term vision and goals of the company.



II. The Plan

As you move through the creation phase for your COA, there are a number of things you should consider.

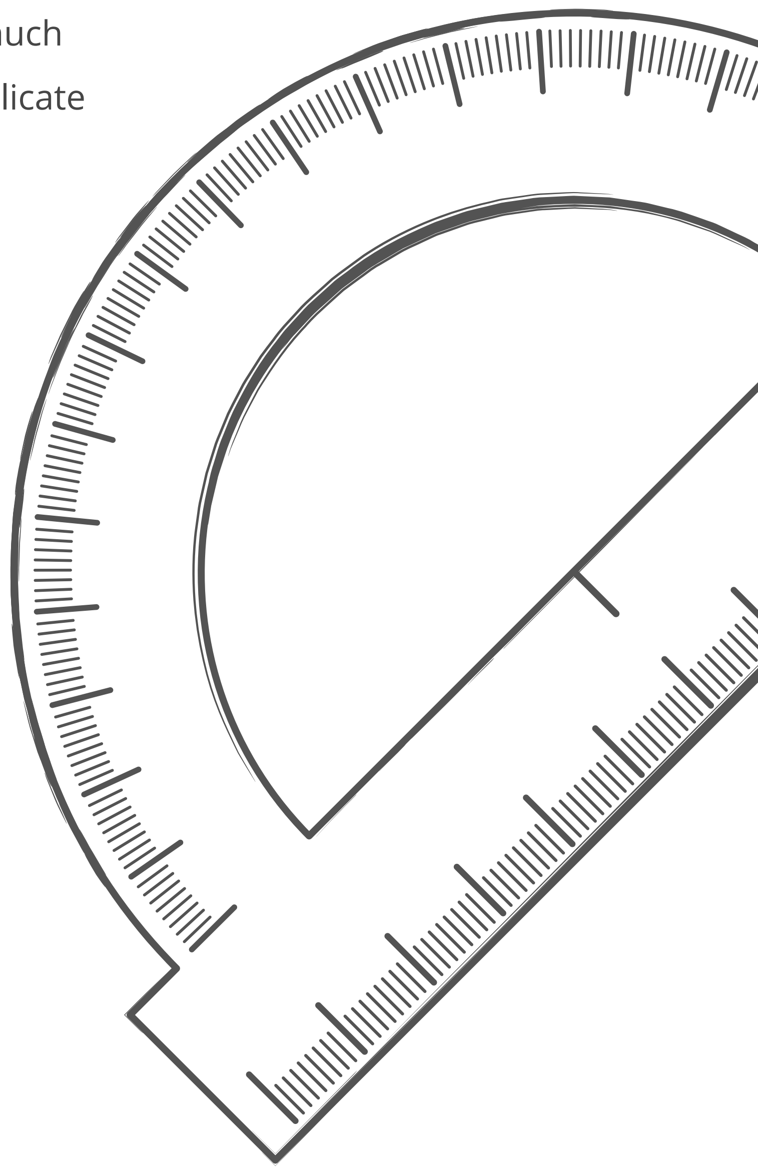
INCLUDE THE BUSINESS

Although the main objective of the COA is to record, track, and report business transactions with an accounting impact, designing it can't be isolated to the finance group alone. For the COA to be a successful working tool, a broad range of stakeholders in the organization need to be involved. To make the COA relevant, you should include input from operations, IT, HR, and senior team members. If you are a multi-site or global company, be sure to include feedback from representatives in all locations.

Many dysfunctional COAs are the result of a lack of understanding of the needs of the entire organization, and were designed by the finance group in isolation. Including a broader range of input can help identify potential weaknesses in the COA, allowing it to be adjusted before implementation.

KEEP IT SIMPLE

Although you want to be able to provide as much detail as possible, be careful not to overcomplicate the COA. Consider the skill level of your internal accounting team who will be responsible for day-to-day management of the COA. Making it too complex could require additional training. For example, you may have a general ledger account for office supplies. Breaking that down to smaller categories like paper, toner, and writing supplies just adds extra work and confusion when it comes to coding invoices.



KEEP IT FLEXIBLE

You need to find the right balance between rigid simplicity and unwieldy complexity. Most times this will be dictated by the size, function, and structure of your business. In all cases make sure you design your COA to be scalable so that it can easily adapt as the business evolves over time. You can accomplish this through appropriate use of account categories. Make them broad enough to allow you to incorporate changes in the business over time. For example, you might start with a single revenue category, but as the business grows, you can add sub categories to capture revenue by location or product line.

TAKE YOUR TIME

Devote the appropriate amount of time to create your COA. Don't expect to develop something quickly or set it up in one sitting. Develop the COA from beginning to end in a working file. Then walk away and think it over. Share it with stakeholders to get their input. Think about how you want to see your financial statements and what categories are important to your business.

Once the COA has been created and put into use, the base can't be changed without throwing everything off. You'll be able to add more detail if you set it up with some scalability, but you won't be able to change the basic foundation. Making any changes down the line will distort period comparisons and will limit the effectiveness of your reporting.

UNDERSTAND YOUR REPORTING NEEDS

Deloitte reports that 40% of CFOs say reporting demands have increased and the need to understand company financial performance is a top priority.[1] The main function of the COA is to organize financial information so that it can be shared with relevant stakeholders in the business. Understand what reports will be needed so you can take that into account as you create the COA. This is especially critical in allowing the businesses to forecast financials during the budgeting process. It's important that the COA line items can be calculated based on the underlying assumptions that drive the business because those are the metrics that can actually be projected.

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1 *Unlock value through your Chart of Accounts*, by Sue Yen and Donal Graham, Deloitte, August 2012.

There are two main groups who will need accurate, timely reporting.

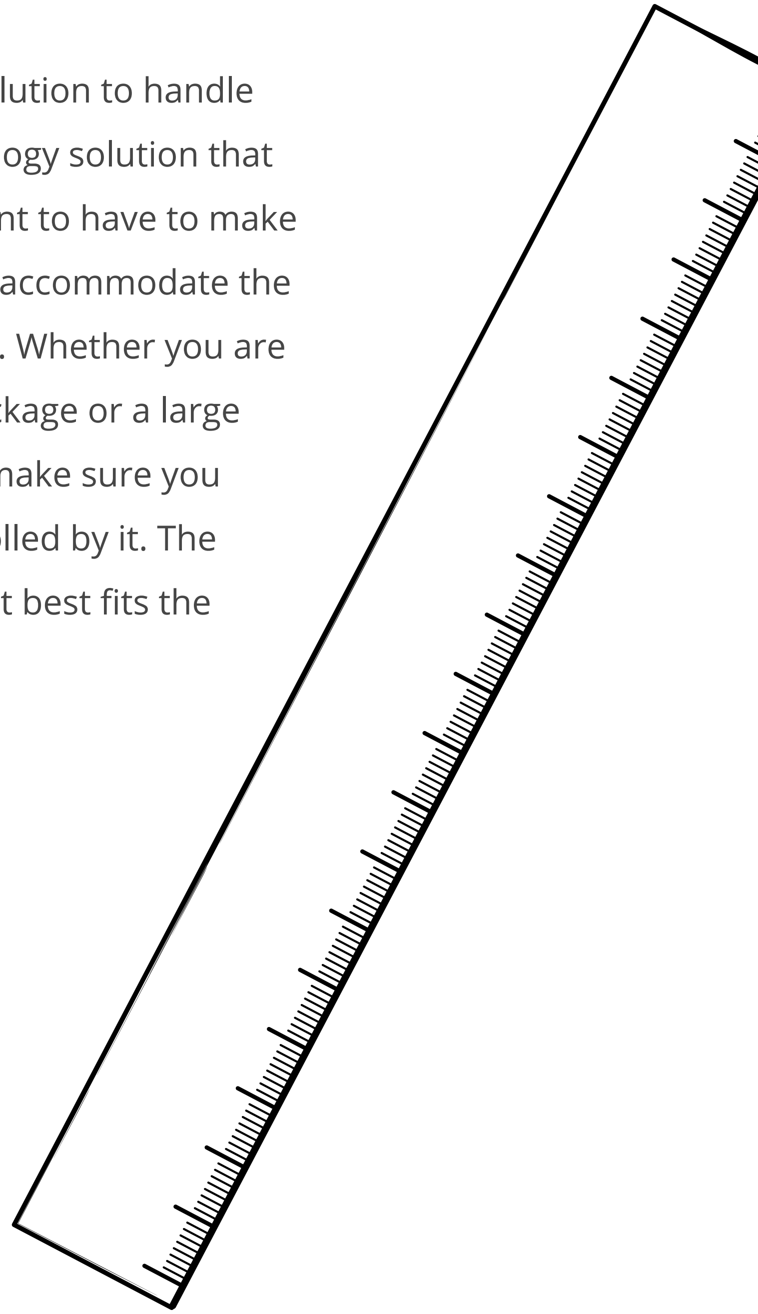
Management: Everyone in a decision making role from the CEO down to department managers will need the information that will be reported out of the COA. Decisions involving labor, materials, sales and marketing, and IT will be based on the financial statements so it is crucial that they be accurate and understandable. That all begins with accurate transaction reporting into the COA.

Auditors: From time to time outside parties will need to review your financials. These can be auditors from your own accounting firm, your bank, or in rare cases representatives from large customers or suppliers. Your COA should be set up to present a clear and accurate picture of your financial situation to these critical third party entities.

Regulators: Government and regulatory agencies have dramatically increased their demands for reporting from businesses of all sizes. Providing clear, detailed reports is the best way to keep them satisfied.

CHOOSE THE RIGHT TECHNOLOGY

Nearly all companies today use a software solution to handle their accounting functions. Look for a technology solution that aligns with your business goals. You don’t want to have to make compromises in how you set up your COA to accommodate the restraints of a particular software application. Whether you are a small business using a basic accounting package or a large enterprise with a multi-module ERP system, make sure you leverage the technology without being controlled by it. The key point is to choose a software solution that best fits the needs and goals of your company.



III. The Pitfalls

Navigating the path to an effective COA can be dicey, and there are pitfalls along the way you want to avoid. Be on the lookout for some of these most common ones.

GETTING THE LEVEL OF DETAIL RIGHT

This is probably the trickiest one. Sometimes, in an effort to address every possible situation, you can end up cluttering your COA with too much detail. Setting up too many general ledger accounts and adding too much detail in the selling and expense accounts can result in an overly complicated COA. That will only lead to confusion when trying to code transactions.

The opposite problem is not providing enough detail. This most often occurs in the revenue and cost of goods sold categories. Setting up a single line for each doesn't provide enough information for stakeholders to analyze where revenue is coming from and which expense categories are driving costs.

The goal is to have the minimum number of accounts with enough detail to help make effective business decisions. This balance will vary greatly depending on the size and complexity of your businvess.

EXAMPLE

Download 3 numbering examples in this **Google Spreadsheet**

http://bit.ly/1IpQUoI

NO LOGIC IN THE GL NUMBERS

Whichever numbering system you choose, make sure you maintain a logical pattern. This allows for clear definition of departments, accounts, and sub-accounts.

Not having a logical order for your account numbers or failing to group them in an understandable way can also cause problems down the line. Staff will struggle when coding transactions and that can result in inconsistencies that will affect the reliability of your financial reporting.

EXAMPLE

Basic Numbering Systems	More Extensible Number Systems
100-199 Assets	10000-19999 Assets
200-299 Liabilities	20000-29999 Liabilities
300-399 Equity	30000-39999 Equity
400-499 Revenue	40000-49999 Revenue
500-599 Cost of Goods Sold	50000-59999 Cost of Goods Sold
600-699 Expenses	60000-69999 Expenses
700-799 Other Revenue & Expenses	70000-79999 Other Revenue & Expenses

Some accountants prefer to use periods or hyphens to make longer account numbers more digestible, while others opt to insert letters at the end of account numbers. It's a matter of personal preference, but choose something that can be logically explained and then implemented by your team.

POOR TITLES

Avoid vague line item descriptions or acronyms when setting up titles. They can be perfectly understandable to the accounting team but will cause confusion when sharing information with other business stakeholders and reporting on financial data.

EXAMPLE

Consider the account 'Fees' — one part of the solution is to create a clear account description like 'Fees from Customers' or 'Bank Fees'. The other is to leverage your account numbering system where one of those will appear under the 400s Revenue and the other will appear under 700 Other Expenses.

CATEGORY MISALIGNMENT

Two critical categories in your COA are revenue and cost of goods sold (COGS). In order to properly report on performance, these two accounts must be aligned. For example sorting revenue by product but COGS by department will prevent relevant matching by anyone trying to analyze business activity. Both accounts should be sorted and aligned using the same methodology.

LACK OF STANDARDIZATION

The lack of standardization is especially problematic in companies with multiple sites or divisions. All business units within the company should have the same COA methodology. This allows consistent reporting at every level and in every part of the organization. If the GL isn't used consistently across the business, periodic financial reporting will not be as effective.

The COA should contain standardized definitions of accounts that are used across all divisions and sites. Inconsistencies will cause aggregated company-level data, such as price or volume increases, to be inaccurate or meaningless.

EXAMPLE

In a board meeting, one of the directors notices that Sponsorship spend has increased from $50,000 to $100,000 and Advertising has dropped from $150,000 to $100,000. A question is raised around the strategic decision that led to a 100% increase in sponsorship spend and a 33% decrease on advertising spend. However, this is actually a distraction because, in reality the Western division had a different interpretation of what the Sponsorship vs. Advertising categories should include.

LACK OF COA OWNERSHIP

This is not usually a problem in a business with a smaller accounting team. However it can be an issue in larger, multi-site corporations. The COA will change over time to meet the evolving needs of the business. Someone must be responsible for keeping the COA up to date with changes in business models and regulatory requirements.

NO LINK BETWEEN COA AND KPI'S

The COA is a means to an end, and should be aligned with business goals and key performance indicators. Establishing and striving to meet appropriate KPI's are critical to business success. The COA and GL should be tied closely together since most KPI's contain financial measurements. Being able to report on KPI's is a critical element in the continuous improvement process.

LACK OF TRAINING

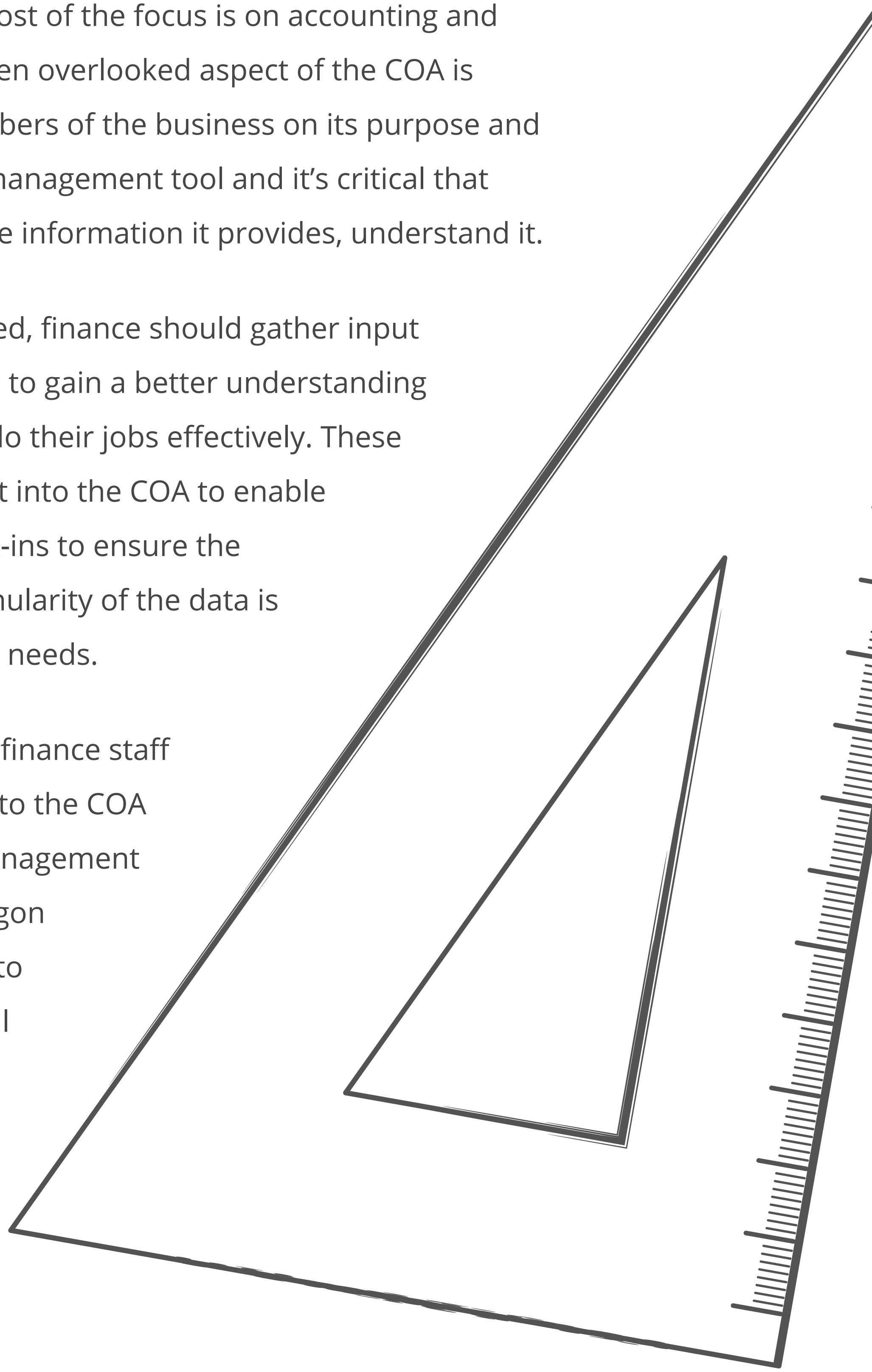
Despite all the hard work you put into setting up the COA, its effectiveness can be negated if staff don't understand how to properly use it. Spend time training not only on the mechanics of the COA, but also on the thought process that went into creating it. This will give staff a better understanding of the purpose and goals of the COA and will improve chances they will use it properly.

NEGLECTING NON-ACCOUNTING STAFF

When setting up the COA, most of the focus is on accounting and financial implications. An often overlooked aspect of the COA is including non-financial members of the business on its purpose and use. The COA is a business management tool and it's critical that stakeholders, who rely on the information it provides, understand it.

As the COA is being developed, finance should gather input from non-accounting groups to gain a better understanding of the metrics they need to do their jobs effectively. These requirements should be built into the COA to enable periodic follow up and check-ins to ensure the structure, accuracy, and granularity of the data is appropriate for the business needs.

Also consider providing non-finance staff with tools to make adapting to the COA easier. Using an expense management tool with non-accounting jargon categories that are mapped to your accounting software will increase the accuracy in how the COA is used.



Summary

Your COA is a crucial component for running your business. Not only is it the foundation of your account and finance functions, but it's also an effective tool for stakeholders in all other areas of the organization to manage the company. Taking the time and thought during the early stages of designing a COA that best suits your business is one of the most important things you can do. Set up properly, the COA will lead to accurate and timely reporting and effective decision-making.

The bottom line? An effective COA is an essential blueprint if you hope to build a successful business.

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