Chapter 11

CURRENT LIABILITIES AND PAYROLL ACCOUNTING

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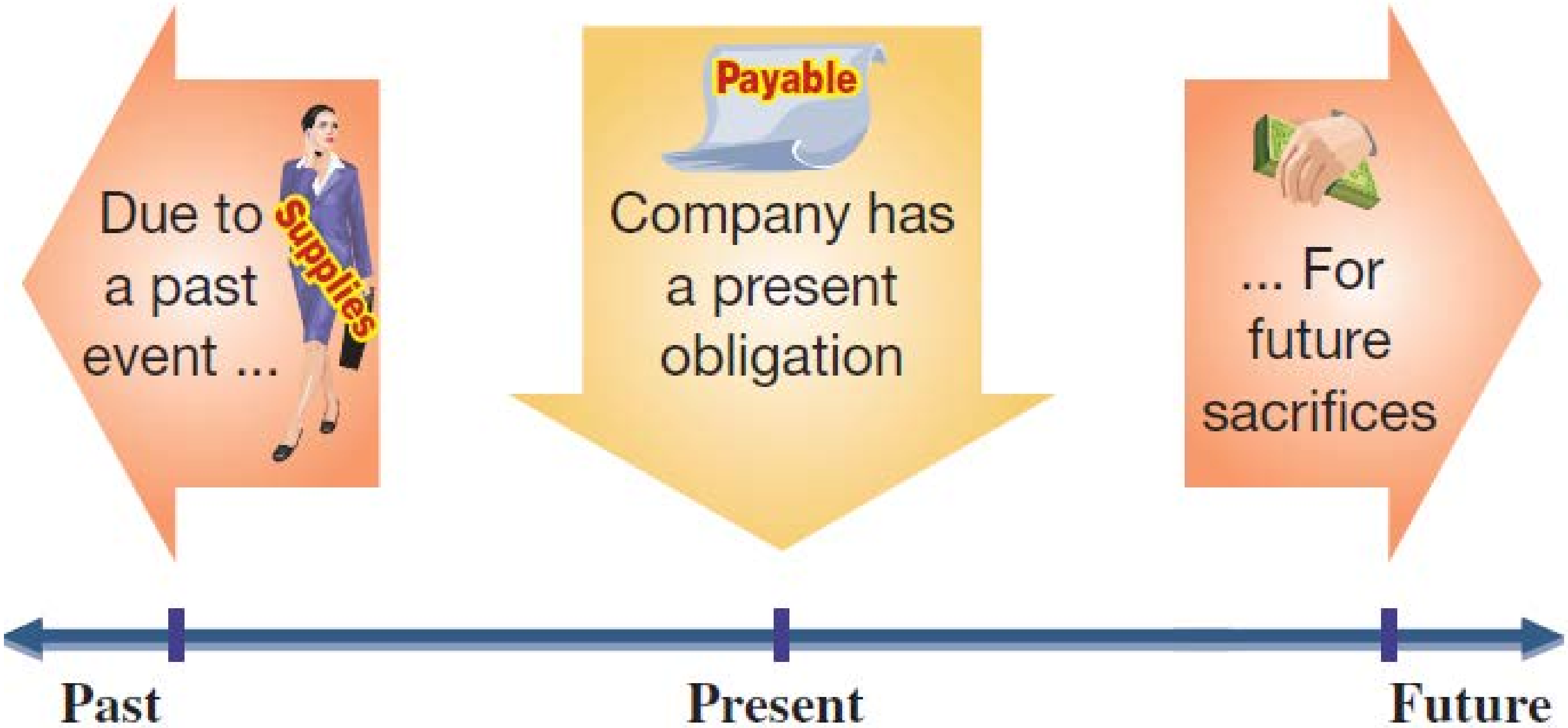
C 1

DEFINING LIABILITIES



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Classifying Liabilities

Current Liabilities

Expected to be paid within one year or the company's operating cycle, whichever is longer.

Long-Term Liabilities

Not expected to be paid within one year or the company's operating cycle, whichever is longer.

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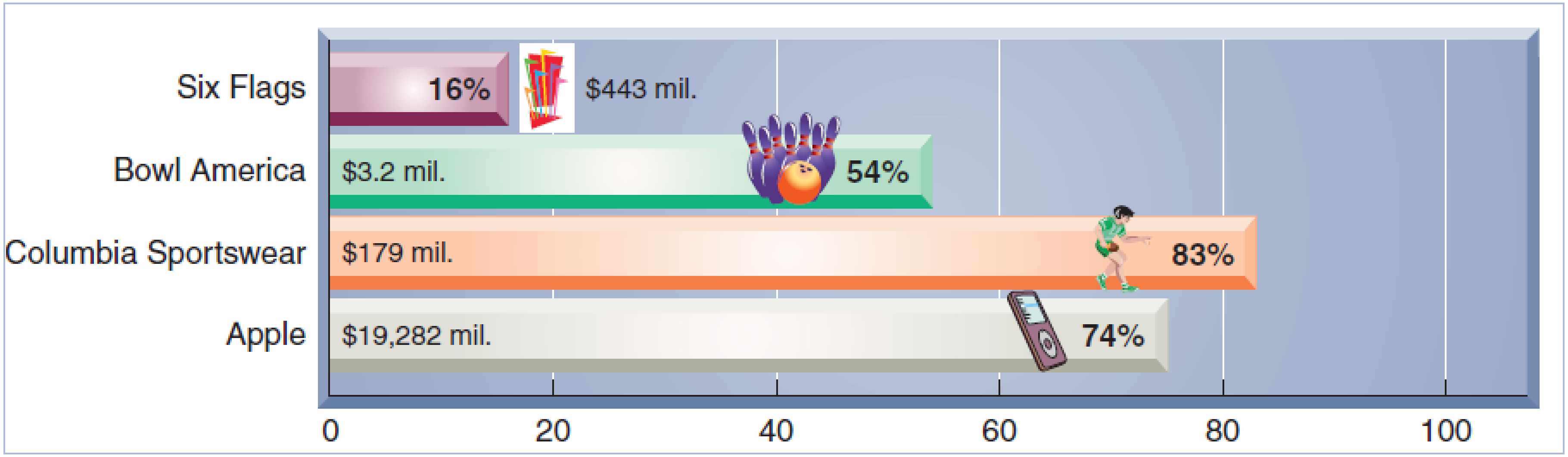
CURRENT AND LONG-TERM LIABILITIES

Current Liabilities as a Percent of Total Liabilities



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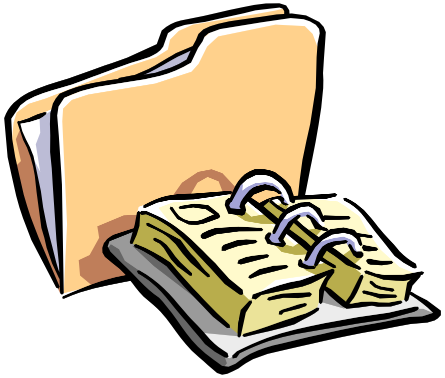
UNCERTAINTY IN LIABILITIES

Uncertainty in Whom to Pay



Uncertainty in When to Pay

Uncertainty in How Much to Pay

C 2

Known Liabilities

Accounts Payable

Sales Taxes Payable

Unearned Revenues

Short-Term Notes Payable

Payroll Liabilities

Multi-Period Known Liabilities

C 2

SALES TAXES PAYABLE

On August 31, Home Depot sold materials for $6,000 that are subject to a 5% sales tax.

Aug. 31	Cash	6,300	
	Sales		6,000
	Sales Taxes Payable ($6,000 × 0.05)		300
	To record cash sales and 5% sales tax.		

$6,000 × 5% = $300

C 2

UNEARNED REVENUES

On June 30, Beyonce sells $5,000,000 in tickets for eight concerts.

June 30	Cash	5,000,000	
	Unearned Ticket Revenue		5,000,000
	To record sale of concert tickets.		

On Oct. 31, Beyonce performs a concert.

Oct. 31	Unearned Ticket Revenue	625,000	
	Ticket Revenue		625,000
	To record concert ticket revenues earned.		

$5,000,000 / 8 = $625,000

P 1

Short-Term Notes Payable

A written promise to pay a specified amount on a definite future date within one year or the company's operating cycle, whichever is longer.

P 1

Note Given to Extend Credit Period

On August 23, Brady Company asks McGraw to accept $100 cash and a 60-day, 12% $500 note to replace its existing $600 Account Payable.

Aug. 23	Accounts Payable—McGraw	600	
	Cash		100
	Notes Payable—McGraw		500
	Gave $100 cash and a 60-day, 12% note for payment on account.		

P 1

Note Given to Extend Credit Period

On October 22, Brady pays the note plus interest to McGraw.

Oct. 22	Notes Payable—McGraw	500	
	Interest Expense	10	
	Cash		510
	Paid note with interest ($500 × 12% × 60/360).		

Interest expense = $500 × 12% × (60 ÷ 360) = $10

P 1

NOTE GIVEN TO BORROW FROM BANK

Promissory Note

$2,000 — Face Value

Sept. 30, 2011 — Date

Sixty days after date, I promise to pay to the order of

National Bank
Boston, MA

Two thousand and no/100 ---------------------------- Dollars

plus interest at the annual rate of 12%.

Janet Lee

P 1

Note Given to Borrow from Bank

On Sept. 30, a company borrows $2,000 from a bank at 12% interest for 60 days.

Sept. 30	Cash	2,000	
	Notes Payable		2,000
	Borrowed $2,000 cash with a 60-day, 12%, $2,000 note.		

On Nov. 29, the company repays the principal of the note plus interest.

Nov. 29	Notes Payable	2,000	
	Interest Expense	40	
	Cash		2,040
	Paid note with interest ($2,000 × 12% × 60/360).		

Interest expense = $2,000 × 12% × (60 ÷ 360) = $40

P 1

END-OF-PERIOD ADJUSTMENT TO NOTES

Note Date

End of Period

Maturity Date

An adjusting entry is required to record Interest Expense incurred to date.

P 1

End-of-Period Adjustment to Notes

On Dec. 16, 2011, a company borrows $2,000 from a bank at 12% interest for 60 days. An adjusting entry is needed on December 31.

2011			
Dec. 31	Interest Expense	10	
	Interest Payable		10
	To record accrued interest on note ($2,000 × 12% × 15/360).		

On Feb. 14, 2012, the company repays this principal and interest on the note.

2012			
Feb. 14	Interest Expense*	30	
	Interest Payable	10	
	Notes Payable	2,000	
	Cash		2,040
	*Paid note with interest. *($2,000 × 12% × 45/360)*		

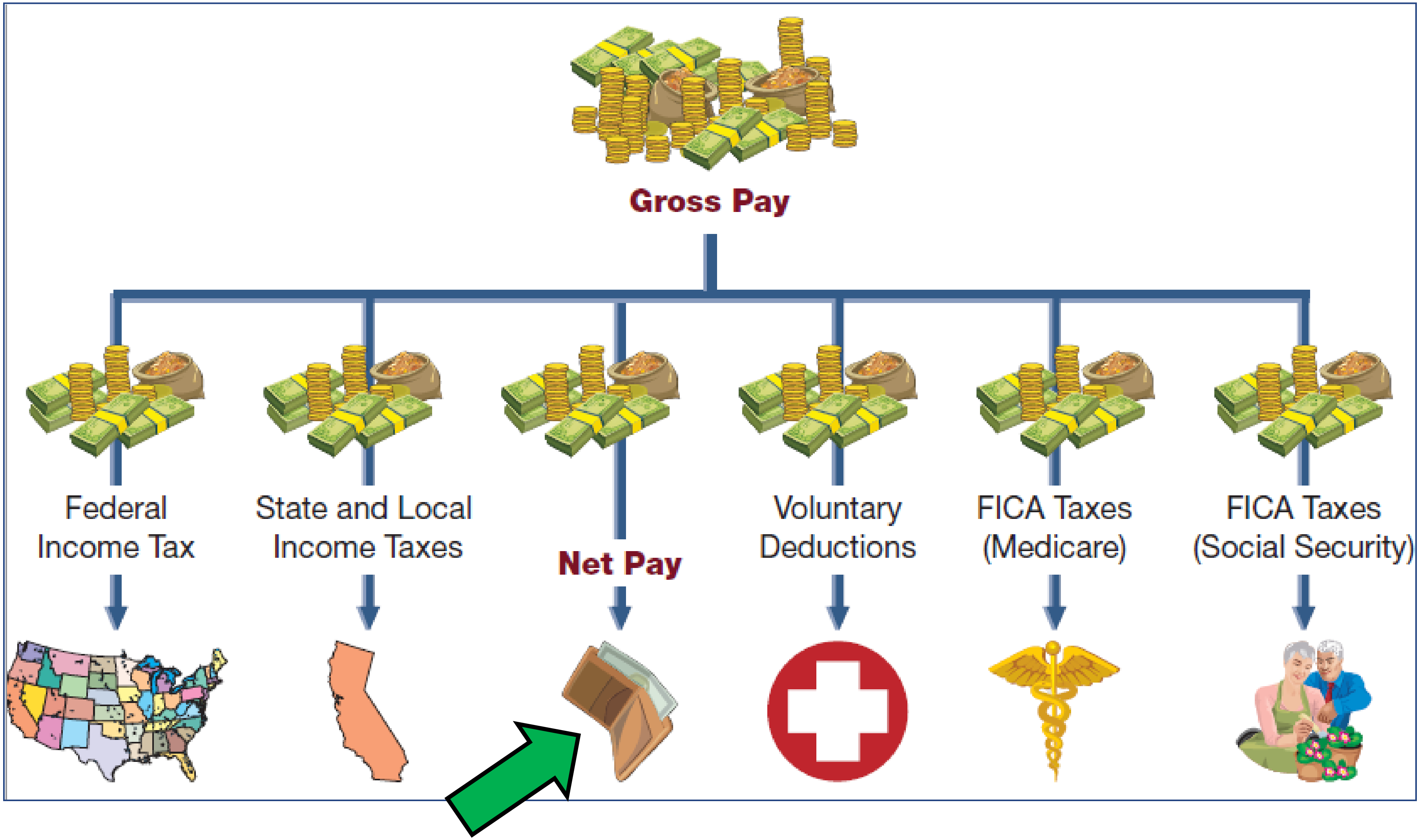
P 2

PAYROLL LIABILITIES

Employers incur expenses and liabilities from having employees.

P 2

Employee Payroll Deductions



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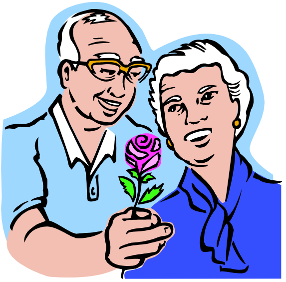
EMPLOYEE FICA TAXES

Federal Insurance Contributions Act (FICA)



FICA Taxes — Soc. Sec.

2010: 6.2% of the first $106,800 earned in the year (Max = $6,621.60).

FICA Taxes — Medicare

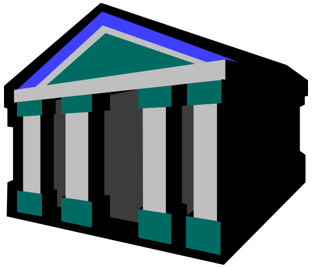
2010: 1.45% of all wages earned in the year.

Employers must pay withheld taxes to the Internal Revenue Service (IRS).

P 2

EMPLOYEE INCOME TAX

Federal Income Tax



State and Local Income Taxes

Amounts withheld depend on the employee's earnings, tax rates, and number of withholding allowances.

Employers must pay the taxes withheld from employees' gross pay to the appropriate government agency.

P 2

EMPLOYEE VOLUNTARY DEDUCTIONS

Amounts withheld depend on the employee’s request.

Examples include union dues, savings accounts, pension contributions, insurance premiums, and charities.

Employers owe voluntary amounts withheld from employees’ gross pay to the designated agency.

P 2

Recording Employee Payroll Deductions

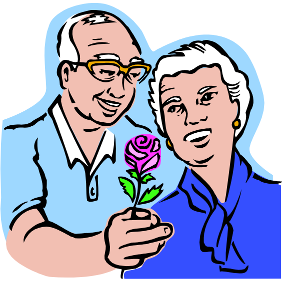
An entry to record payroll expenses and deductions for an employee might look like this.

Jan. 31	Salaries Expense	2,000	
	FICA—Social Security Taxes Payable (6.2%)		124
	FICA—Medicare Taxes Payable (1.45%)		29
	Employee Federal Income Taxes Payable*		213
	Employee Medical Insurance Payable*		85
	Employee Union Dues Payable*		25
	Salaries Payable		1,524
	To record accrued payroll for January.		

Salaries Payable	1,524	
Cash		1,524
To record payment to employee		

P 3

EMPLOYER PAYROLL TAXES



FICA Taxes

Medicare Taxes

Federal and State Unemployment Taxes

Employers pay amounts equal to that withheld from the employee's gross pay.

P 3

Federal and State Unemployment Taxes

Federal Unemployment Tax (FUTA)

2010: 6.2% on the first $7,000 of wages paid to each employee (A credit up to 5.4% is given for SUTA paid, therefore the net rate is 0.8%.)

State Unemployment Tax (SUTA)

2010: Basic rate of 5.4% on the first $7,000 of wages paid to each employee (Merit ratings may lower SUTA rates.)

P 3

RECORDING EMPLOYER PAYROLL TAXES

An entry to record the employer payroll taxes for January might look like this.

Jan. 31	Payroll Taxes Expense	277	
	FICA—Social Security Taxes Payable (6.2%)		124
	FICA—Medicare Taxes Payable (1.45%)		29
	State Unemployment Taxes Payable		108
	Federal Unemployment Taxes Payable		16
	To record employer payroll taxes.		

SUTA: $2,000 x 5.4% = $108
FUTA: $2,000 x (6.2% - 5.4) = 16

FICA amounts are the same as that withheld from the employee's gross pay.

C 2

MULTI-PERIOD KNOWN LIABILITIES

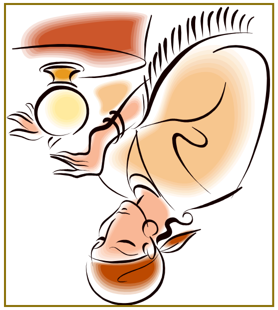
Includes Unearned Revenues and Notes Payable

Unearned Revenues from magazine subscriptions often cover more than one accounting period. A portion of the earned revenue is recognized each period and the Unearned Revenue account is reduced.

Notes Payable often extend over more than one accounting period. A three-year note would be classified as a current liability for one year and a long-term liability for two years.

P 4

ESTIMATED LIABILITIES



An estimated liability is a known obligation of an uncertain amount, but one that can be reasonably estimated.

Examples: pensions, health care, Vacation pay, warranties offered by Sellers, property taxes, contracts For future services

P 4

HEALTH AND PENSION BENEFITS

Employer expenses for pensions or medical, dental, life and disability insurance

Assume an employer agrees to pay an amount for medical insurance equal to $8,000, and contribute an additional 10% of the employees' $120,000 gross salary to a retirement program.

Dec. 31	Employee Benefits Expense	20,000	
	Employee Medical Insurance Payable		8,000
	Employee Retirement Program Payable		12,000
	To record costs of employee benefits.		

P 4

VACATION BENEFITS

Assume an employee earns $20,800 per year and earns two weeks of paid vacation each year.

$20,800	÷	50 weeks	=	$416
$20,800	÷	52 weeks	=	$400
Weekly vacation benefit				$ 16

Vacation Benefits Expense	16	
Vacation Benefits Payable		16
To record vacation benefits accrued.		

DR Vacation benefits Payable CR Cash -when vacation is taken

P 4

Bonus Plans

Assume that a bonus will be paid to employees equal to 5% of the company's annual net income of $210,000.

B = .05 ($210,000 - B)
B = $10,500 - 0.05B
1.05B = $10,500
B = $10,500 / 1.05
B = $10,000

Dec. 31	Employee Bonus Expense*	10,000	
	Bonus Payable		10,000
	To record expected bonus costs.		

P 4

WARRANTY LIABILITIES

Seller's obligation to replace or correct a product (or service) that fails to perform as expected within a specified period. To comply with the full disclosure and matching principles, the seller reports expected warranty expense in the period when revenue from the sale is reported.

P 4

WARRANTY LIABILITIES

On Dec. 1, 2011, a dealer sells a car for $16,000 with a maximum one-year or 12,000 mile warranty covering parts. Past experience indicates warranty expenses average 4% of a car's selling price.

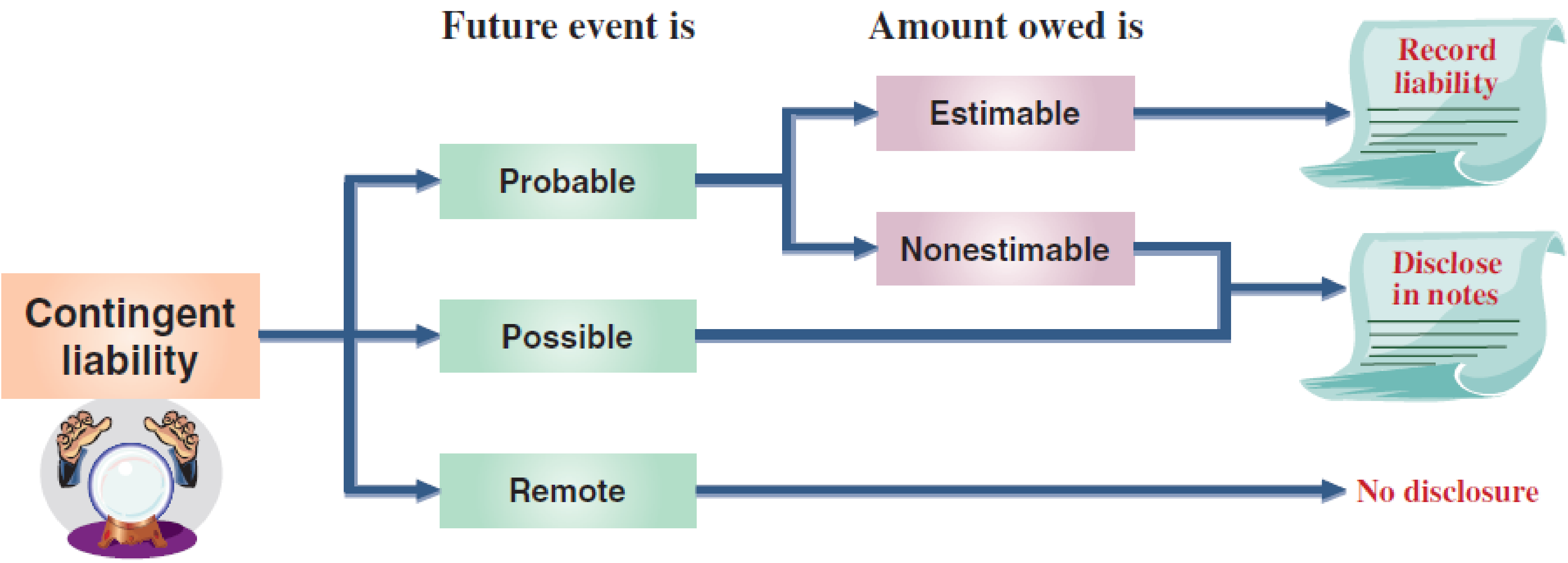
2011			
Dec. 1	Warranty Expense	640	
	Estimated Warranty Liability		640
	To record estimated warranty expense.		

On Jan. 9, 2012, the customer returns the car for repairs. The dealer replaces parts costing $200.

2012			
Jan. 9	Estimated Warranty Liability	200	
	Auto Parts Inventory		200
	To record costs of warranty repairs.		

C 3

Accounting for Contingent Liabilities



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REASONABLY POSSIBLE CONTINGENT LIABILITIES

Potential Legal Claims – A potential claim is recorded if the amount can be reasonably estimated and payment for damages is probable.

Debt Guarantees – The guarantor usually discloses the guarantee in its financial statement notes. If it is probable that the debtor will default, the guarantor should record and report the guarantee as a liability.

Global View

Characteristics of Liabilities

Accounting definitions and characteristics of current liabilities are similar for U.S. GAAP and IFRS. Sometimes IFRS will use the word “provision” to refer to a “liability.”

Known (Determinable) Liabilities

Both U.S. GAAP and IFRS require companies to treat known (or determinable) liabilities in a similar manner. Examples would be accounts payable, unearned revenues, and payroll liabilities.

Estimated Liabilities

Regarding estimated liabilities, when a known current obligation that involves an uncertain amount, but one that can be reasonably estimated, both U.S. GAAP and IFRS require similar treatment.

A 1

TIMES INTEREST EARNED

$$\text{Times interest earned} = \frac{\text{Income before interest and income taxes}}{\text{Interest expense}}$$

If income before interest and taxes varies greatly from year to year, fixed interest charges can increase the risk that an owner will not earn a positive return and be unable to pay interest charges.

P 5

Appendix 11A: Payroll Reports, Records, and Procedures

Payroll Reports

- IRS Form 941
- IRS Form 940
- W-2

Payroll Records

- Payroll Register
- Payroll Checks
- Employee Earnings Report

Payroll Procedures

- Withholding Tables
- W-4

P 5

Appendix 11B: Corporate Income Taxes

Corporations must pay taxes on income.

Deferred Income Tax Liabilities

Example: Assume that a corporation computes $25,000 of income taxes expense and determines that only $21,000 is currently due and $4,000 is deferred to future years (a timing difference).

Dec. 31	Income Taxes Expense	25,000	
	Income Taxes Payable		21,000
	Deferred Income Tax Liability		4,000
	To record tax expense and deferred tax liability.		

END OF CHAPTER 11